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April 1957

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Accounting for Plant Shutdowns

Cash Forecasting

Financial Control of Ontario Municipalities

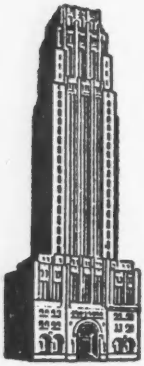
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How the Federal Tax Department Operates

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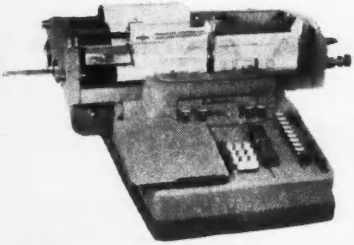


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THE CANADIAN CHARTERED ACCOUNTANT

VOL 70, No. 4 APRIL 1957

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The Canadian Chartered Accountant, April 1957. Published monthly by the Canadian Institute of Chartered Accountants. Chairman, Editorial Board, C. K. MacGillivray, F.C.A.; Editor, Renny Englebert; Asst. Editor, Jean Vale. Advertising Representative, E. L. Vetter. Editorial and business office: 69 Bloor street east, Toronto 5. Subscription rates: $6 a year; 60 cents a copy. Printed by General Printers Limited and mailed at Oshawa, Ontario. Authorized as second class mail by the Post Office Department, Ottawa. Opinions expressed are not necessarily endorsed by the Canadian Institute.



H. F. HERBERT, C.A.

The uncomplicated internal structure of the Federal Government's Taxation Division, as described by H. F. Herbert in "How the Federal Tax Department Operates", is the highlight of this author's timely article. By any standards, the Taxation Division operates a large scale business with collections exceeding $2½ billion annually. The Division employs 6,300 regular personnel in its 30 locations and, according to the author, an able methods group is continually directing its activities to making improvements in procedures and equipment so as to increase the economy of effort and efficiency in all phases of the Division's activities.

Mr. Herbert is Director of Planning and Development of the Taxation Division of the Department of National Revenue and has served in various branches of the Division during the past 12 years. He obtained his certificate in chartered accountancy in 1944 and is a member of the Institutes of Chartered Accountants of British Columbia and Alberta.

A. F. D. CAMPBELL, C.A.

Adequate methods of forward planning play a large part in providing business with the necessary degree of adaptability to enable it to survive and prosper. With the use of modern techniques of cash forecasting, it is possible to make a thorough survey of the sources from which cash will flow into a business and determine a relationship between short and long term financing arrangements.

After expressing this viewpoint, Desmond Campbell, author of "Cash Forecasting", outlines the normal starting point of the cash forecast. He takes the reader through the various stages covering sales and market projection, the purchasing program, financial implications of the labour bill and outlines the effect of each on the various phases of the forward planning program.

As associate controller of Ford Motor Company of Canada Limited, Mr. Campbell is closely associated with the function of financial planning. Before joining Ford he spent some years as vice-president and director of Stafford Foods Limited and Stafford Metal Industries Limited. From 1945 to 1950 he served with the International Refugee Organization in Geneva as director of accounts and audits and controller concurrently, which involved him in the operation of over 40 sea-going vessels and an immense purchasing program to provide food and medical care for millions of European refugees. He draws upon this experience of balancing forward expenditures with anticipated revenues for a great part of his knowledge of the extensive use of modern techniques of forward planning. Mr. Campbell articled with Peat, Marwick, Mitchell & Co., Winnipeg and, since 1941, has been a member of the Institute of Chartered Accountants of Manitoba.

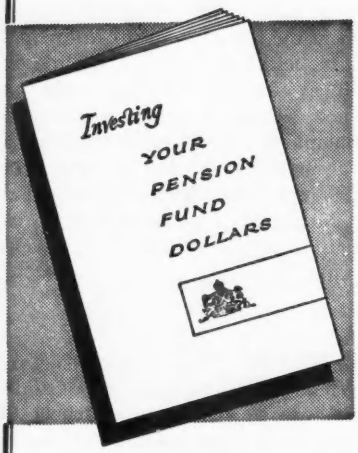
PAUL HICKEY, C.A.

Urbanization has brought increased demands not only for current services of municipal governments but for services involving large capital expenditures. The preparation of annual estimates today is a formidable task and requires the experience of a well

Continued on page 296

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Continued from page 294

qualified accounting staff before the treasurer is faced with the job of guiding these estimates through the Board of Control and the Council. In "Financial Control of Ontario Municipalities", Paul Hickey who, at 31 years of age, was appointed treasurer of Canada's 5th largest city, looks at the problem of municipal financial control and its relationship with the Government of Canada and the Province of Ontario from the point of view of an insider with considerable experience.

Mr. Hickey has been teasurer of the City of Hamilton since 1954. He began his work in the municipal field in 1950 in the Department of Municipal Affairs before going to Hamilton in 1953 as assistant commissioner of finance. He is a frequent speaker on municipal financial topics. Mr. Hickey is a member of the Institute of Chartered Accountants of Ontario and the Municipal Finance Officers Association of the United States and Canada.

W. S. HULTON

When a small company needs additional capital it can only expect to succeed in tapping potential sources if it possesses unusual attractions which can stand up under searching and expert examination. It should be remembered also that the lender, who cannot be an expert in every industry, will want to know all about the company and the people in it. In "Capital for Small Business" Wm. S. Hulton tells how, in the course of his work, he appraises the financial management of a company for investment purposes and what steps should be taken by the company to ensure that it is in a good position to warrant putting in risk capital.

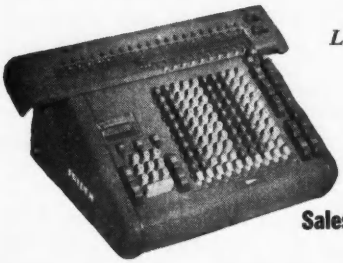
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Continued from page 296

Mr. Hulton is a graduate of Oxford University and served his chartered accountancy apprenticeship with George A. Touche and Company, London, England. In 1953 he started the Canadian subsidiary of the Charterhouse Industrial Development Company Limited, an English firm which was organized to assist, by direct investment, the expansion of small and medium sized companies in Canada. He is currently vice-president and general manager of Charterhouse Canada Limited. Mr. Hulton is a member of the English Institute of Cost and Works Accountants and the Institute of Chartered Accountants of Scotland.

H. M. BELYEA, C.A.

A new approach to the problem of accounting for fixed charges during a period of no operations is proposed by Harry M. Belyea in "Accounting for Plant Shutdowns". The author outlines a system whereby overhead and profit variances during shutdown periods will be recognized and overhead, administration and other charges assessed accordingly.

Mr. Belyea is comptroller of Canadian Aviation Electronics Limited (Western Division). He obtained his certificate in chartered accountancy in 1948 and is a member of the Institute of Chartered Accountants of Manitoba.

EDITORIAL

One of the most convincing signs that the accounting profession has won public recognition is its willingness to work for the public without thought of personal gain. In "For the Common Good", this month's editorial by John A. Wilson, the author draws attention of readers to a particular case of such public service. It can be duplicated many times by other examples of how the profession is taking an active part in matters affecting the economic welfare of the country and its citizens.

Mr. Wilson is a partner in George A. Touche & Co., with whom he has been associated since 1928. He obtained his certificate in 1933 and was elected a Fellow of the Institute of Chartered Accountants of Ontario in 1947. A past president of the Ontario Institute and former chairman of the Board of Governors, Canadian Tax Foundation, Mr. Wilson is now a member of the Executive Committee of The Canadian Institute of Chartered Accountants.

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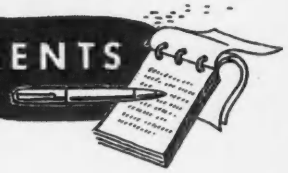
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NOTES AND COMMENTS



"Accounting Terminology"

An extended study sponsored by the Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants has resulted in the publication this month of "Accounting Terminology", a dictionary of the major accounting terms and phrases. This volume, kept to convenient size by careful selection, presents simple concise definitions, more elaborate explanations where required, as well as alternative meanings in accounting and other contexts. It is available from the Canadian Institute at $2.00 to members, $2.50 to others.

Members Directory 1957-58

The preparation of the 1957-58 edition of the Directory of Canadian Chartered Accountants is now under way and forms are currently being sent to all members with a request to return them to the printer promptly. It is important that this be done to ensure accurate and complete listings. It is expected that the directory will be published in September.

Topical Research Bulletin

"Statements without Audit" is the subject of Accounting Research Bulletin No. 13 issued last month by the C.I.C.A. Committee on Accounting and Auditing Research and mailed to every member of the Canadian Institute. Realizing that many practitioners are called on to prepare financial statements without sufficient examination to permit the expression of an opinion, the Research Committee recommends that each such statement should be accompanied by a disclaimer by the accountant which makes it clear that he is not giving an opinion. The full text of the bulletin appears on page 342-3 of this issue. It is available from the Canadian Institute to non-members at 15c a copy.

Brochure on Grain Accounting

In response to several requests, the series of articles on grain accounting, which has appeared in *The Canadian Chartered Accountant* during the past year and a half, is being published in booklet form. Orders for copies may be placed now at $1.25 each, or $1.00 each for quantities of 25 or more.

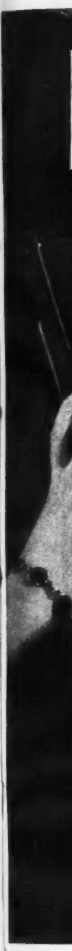
Board of Examiners Meet

The Board of Examiners-in-Chief of the Provincial Institutes of Chartered Accountants will meet at Mont Gabriel, Quebec on April 11, 12 and 13 to prepare the 1957 uniform examinations.

C.I.C.A. New Staff Member

Gordon Kennedy has recently joined the staff of the Canadian Institute as press and public relations officer. Mr. Kennedy comes to the Institute from the Turnbull Elevator Company Limited where he served as editor of the company's external magazine with special responsibilities

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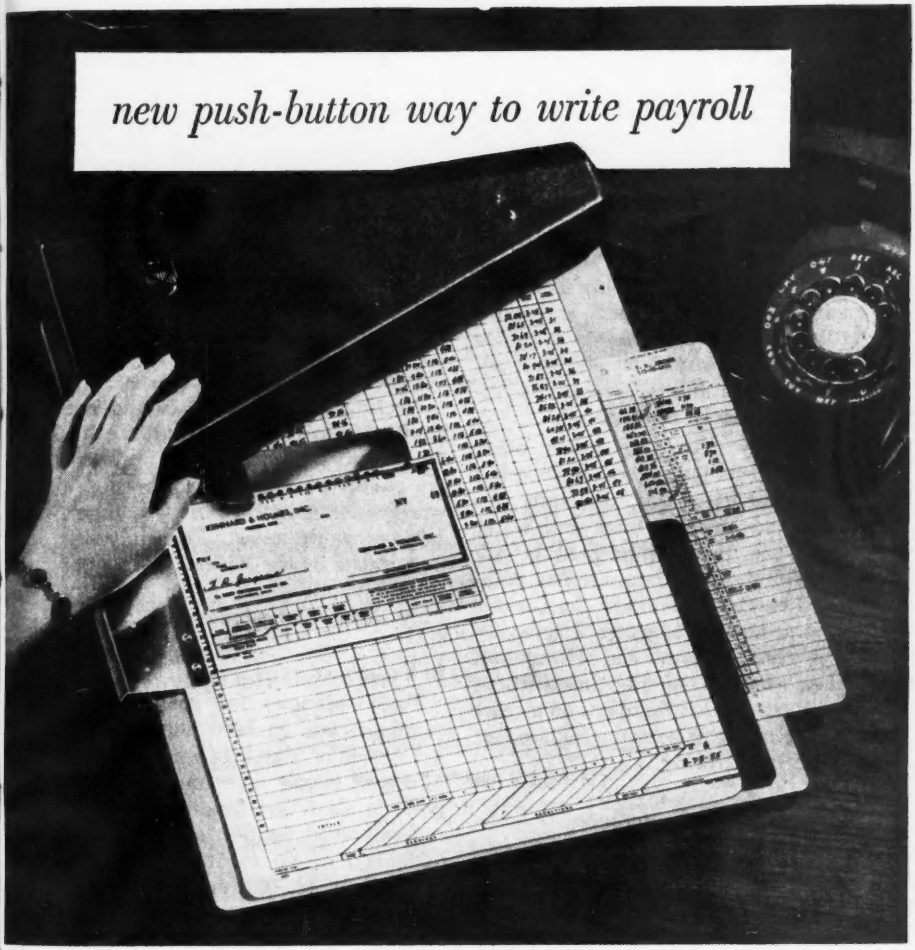


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in public relations and sales promotion. He was previously for 7 years with Canadian National Communications in Toronto working in the editorial and promotional field.

Punched Cards for Tax Accounting in Winnipeg

On January 1, 1957 the city of Winnipeg began processing its assessment roll, tax roll, tax bills, and water utility bills on punched card equipment. This makes Winnipeg's accounting and billing procedures almost completely mechanized.

The city has also made other changes in its tax procedures. It has discontinued use of discounts for realty and business taxes and water bills when these were paid in advance of the due date. It has authorized chartered banks in the Greater Winnipeg area to accept city realty taxes during the months of May and June, when taxes are due without penalty, provided there are no arrears and the taxpayer pays the full amount of the taxes owing.

Inter-American Conference

The Inter-American Accounting Conference will hold its fourth meeting in Santiago, Chile, November 15-23, 1957. Last meeting of the conference was held in Sao Paulo, Brazil, in November 1954.

Meeting for Integration

More than 2,000 members of the Institute of Chartered Accountants in England and Wales attended a special meeting of the Institute in February when the first official step was taken towards putting into effect the proposed plan for integrating the Society of Incorporated Accountants with the three British Institutes of Chartered Accountants. The resolution submitted to the meeting was passed with the required two-thirds majority. A poll of the whole membership of the Institute has still to be taken.

Accounting among Nations

That the national accounting of many countries may one day be expressed in one language is the hope contained in a group of reports recently published for the National Bureau of Economic Research by Princeton University Press. Based on a meeting called by the Conference on Research in Income and Wealth, the reports deal with some preliminary results of a project to develop a worldwide accounting of transactions between world areas. The study was undertaken by the National Bureau of Economic Research under a grant from the Ford Foundation.

In Parliament:

Welcome news for chartered accountants was contained in the budget speech of March 14 when Finance Minister Harris announced a proposal to allow professional and other self-employed people to claim a tax deduction of up to 10% of earnings (maximum $2,500) on payments to approved retirement savings plans. Taxpayers now participating in employee pension plans may purchase eligible annuities outside the plan to a limit of $1,500 for the total of pension plan and annuity payments. It is expected that a system would be set up whereby the portion of insurance premiums covering an annuity provision within an insurance policy will also be deductible.

Under the provisions of the budget, dues paid to professional societies may be deducted even if they are not a condition of employment. The tax-

Continued on page 304

Announcing

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Continued from page 302

payer may take the option of a flat deduction of $100 from personal income on account of medical expenses, charitable gifts, and union or professional dues. Other features of the budget include slight increases in family allowances and old age pensions and the removal of the 10% sales tax on tea, coffee, cocoa and other groceries.

The Government of Canada ended its fiscal year on March 31 with a surplus of $282½ million and anticipates a surplus of $152 million for the coming year.

A full commentary on the provisions concerning pension payments for the self-employed will appear in the May issue of this journal.

* * *

M. J. COLDWELL: In view of the enormous profits that are made on Trans-Canada Pipe Lines, Trans Mountain Pipe Line and so on, does the Minister not consider that it is time we should be considering a capital gains tax?

HON. W. E. HARRIS (MINISTER OF FINANCE): It has always been the policy of this government and, so far as I know, it is at this moment, that we would not impose a capital gains tax. As far as I am concerned, I am not prepared to recommend it to my colleagues.

— *Hansard,* February 19, 1957

* * *

E. G. HANSELL: Is it expected that there will be any revision in the Succession Duty Act at this session?

HON. W. E. HARRIS (MINISTER OF FINANCE): The House may recall that we did say last year that we expected to bring forward the revision of the Succession Duty Act. We were not able to do that, as hon. members may suppose from the length of the session. We have a revision almost complete at the present time but I do not think there will be an opportunity during this session to bring it before the House.

— *Hansard,* February 19, 1957

Canada Year Book 1956

The 1956 edition of The Canada Year Book has just been published by the Dominion Bureau of Statistics. Special feature articles in this edition include "Mapping and Charting in Canada", "Financial Administration of the Government of Canada", "The National Capital Plan" and "The Federal-Provincial Forestry Agreements". Copies are available from the Queen's Printer, Ottawa, at $4 each.

Cost Accountants Conference

In a 3-day integrated meeting at the Banff Springs Hotel from June 24 to 26, the 36th Cost and Management Conference of the Society of Industrial and Cost Accountants of Canada will study the three aspects of identifying, assessing and financing specific sources of profit. Addresses will be given by F. S. Capon, C.A., secretary and treasurer, Du Pont Company of Canada (1956) Ltd., Montreal, Dr. Joel Dean, president, Joel Dean Associates, Hastings-on-Hudson, N.Y., and J. G. Chaston, secretary-treasurer, Pemberton Securities Ltd., Vancouver.

In the News

LOUIS JACOBS, F.C.A. (Sask.) has been appointed Deputy Minister of Municipal Affairs of the Province of Saskatchewan.

Help Fight Cancer

The money raised during the Canadian Cancer Society's campaign for funds this month will be used to support a rapidly expanding cancer research program, cancer education and welfare services.

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Editorial

FOR THE COMMON GOOD

MEMBERSHIP in a profession involves a responsibility to the community and public generally, over and above the more mercenary objectives of performing adequate technical services for specific clients. Chartered accountancy is no exception, and our members have demonstrated a willingness to recognize this obligation.

One example of their public service is the work of the Joint Committee on Taxation of the Canadian Institute of Chartered Accountants and the Canadian Bar Association which has recently received publicity in the financial and daily papers.

Practising chartered accountants are well qualified to act as tax consultants to their clients. Knowing that the more difficult the taxation problems are, the more the clients will require their help, they might have taken the narrow view and kept their "trade secrets" to themselves with the hope of reaping greater financial benefits. It is a real acceptance of their professional responsibility to serve on this joint committee working for the common good without thought of personal gain.

In selecting subjects for recommendations, the committee draws not only upon its own members but upon the Taxation Committees of Provincial Institutes. The latter, in addition, frequently arrange public meetings to discuss tax matters and invite business people and members of other professions to attend.

All this effort culminates in a brief which is jointly prepared and forwarded to the Ministers of Finance and National Revenue. Shortly after, representatives of the committee make a personal visit to Ottawa to talk about the points raised.

Over the years the submissions of the joint committee have been predominantly on income taxes but they also cover the Excise Tax Act. Some have involved major government policies; others have dealt with unfortunate wordings in legislation and regulations, inconsistent application of principles, differences between the taxing authority application and business practice, inequities, etc. While it cannot be claimed that all of the committee's recommendations have been adopted, it is safe to say they have played an important part in bringing about amendments in the Acts. The reception accorded these submissions in Ottawa indicates that the government representatives regard them as constructively helpful.

In addition to rendering a service, by submitting these joint recommendations, our members are showing the advantages of having the chartered accountant and the lawyer work together, each contributing his special skill and experience.

Another symbol of public service and of cooperation with the other professions is the Canadian Tax Foundation, co-sponsored by the Canadian Institute of Chartered Accountants and the Canadian Bar Association. This non-profit organization, widely recognized for its independent research in the fields of taxation, contributes in a very important way to the dissemination of authentic tax information and to the development of better taxation laws and procedures.

It is through work like this that the members of the Canadian Institute have earned the reputation they enjoy with the public and government alike. Their adherence to high professional principles has made it possible for them to render valuable assistance to clients and, at the same time, preserve their independence and place of honour in the community.

Cash Forecasting

A. F. D. CAMPBELL

INDUSTRIAL PROGRESS IN the past decade has introduced a new rate of speed and complexity into the conduct of business. Economic changes are sharper; obsolescence rates are higher; competition is keener; vague possibilities have a way of translating themselves suddenly into startling realities. The risks of trade in this volatile market have risen greatly, but the opportunities for improved earnings are immense. Modern business has found it more necessary than ever before to take a watchful, searching and coordinated approach to the future. Forward planning has become one of the most serious preoccupations of top management.

A fundamental element in forward planning is the establishment of a continuous balance between the cash position and the other aspects of the plan. Otherwise, of course, vital parts of it may be encumbered or brought to a complete halt through lack of liquid funds; or conversely, accumulations of cash may be immobilized, with consequent loss of potential earnings.

Normally, the whole forward plan, of which the cash forecast is an integral part, can be set forth in fairly realistic terms and in meaningful detail for several months ahead. Thereafter, the plan becomes of necessity more generalized and may be projected from three to five or more years. The short term plan, being measurable against recent actual performance and current trends, will bear on those relatively tangible problems already facing the business and demanding immediate attention. The long range plan is subject to such broad influences as national economic trends, the effect of technological and competitive progress on customer demand, and the development of new products and new markets. These forces direct management into continual reappraisal of manufacturing facilities, methods of procuring materials, labour supply and of the future cost-selling price relationships. In all of this work, the cash forecast plays an important role because it covers an area which is highly sensitive to changes of all kinds.

Determining Sales Projection

The normal starting point of the cash forecast is the determination of the gross sales figures upon which the production, purchasing, facility and most other aspects of the forecast depend. It is therefore desirable that

the sales projection be expressed in the greatest degree of detail for which there is logical support. Accuracy in sales forecasting is essential, and it is almost needless to remark that inaccuracy will render the cash forecast quite useless, if not harmful.

The accurate determination of sales requires a thorough survey of the market available to the entire industry for products of a similar or allied nature. It is then necessary to contemplate the share of this market which is feasibly obtainable by the particular business, both on the short and long term. Here consideration must be given to the competitive status of its products in price, quality, reputation, and all other aspects bearing on customer acceptance. The development of such a sales potential will generate a number of questions which are worthy of careful study and management decision. To what extent does the sales potential match the existing manufacturing facilities, marketing organization and manpower supply of the business? Of the available market, what selection of products is best calculated to maximize sales of the profitable lines and still provide assurance of adequate volume to cover fixed charges? To what extent are the risks involved in expansion of facilities justified by the return which the attainable added volume will yield? If an investment is made in additional plant, how long will it take to recover the cash so expended through the marginal cash revenue arising from the added volume? These or similar questions need to be answered in conjunction with the proper determination of projected sales.

For the purpose of the cash forecast it is, of course, necessary to plot the sales projections in terms of gross cash receipts. This procedure may be quite complicated depending on the nature of the business. Frequently, certain products or portions of certain product lines will be sold to customers whose payment habits vary from normal credit terms. Also, the payment behaviour of the same customers may vary on a seasonal pattern throughout a year. Where the company is engaged in export operations, the cash forecast must make allowance for shipping delays and foreign exchange transactions. Since the cash forecast deals in gross revenue, it is necessary to include in the sales revenue such additional items as freight and taxes, where it is the practice for the vendor to pay and add them to the invoice. These added charges often bulk quite large and may differ considerably among types of products and the geographical destination points of delivery. These are but a few examples to illustrate the factors which are encountered in the accurate forecasting of sales revenue. Once a business has gained experience in this type of close estimating, it is usually possible to develop a number of mathematical formulae, the use of which not only speeds preparatory work but also ensures that no factors are overlooked.

Estimating Material Requirements

After the sales projection, the next most important item in forward planning is usually the estimate of purchased materials. It is an area where the planning techniques can contribute tangibly to improved results.

The sales projection provides a guide so that material requirements can be plotted into the future. With advance knowledge, the procurement of material purchases can be explored

more thoroughly, and full advantage can be taken of competitive situations as well as seasonal fluctuations in a variety of commodity markets. Also, negotiations can be discussed in terms of larger quantities at more favourable prices. Therefore, while the buying will be based on the sales projection, there may be a considerable time lag between receipt of cash and the demands for cash disbursements created by the purchasing program. Advantageous purchasing arrangements may frequently cause a heavy drain on cash funds during a period when sales revenue is at a low point. Conversely, cash accumulations from sales may pile up in a later period when the business is realizing on an inventory bought in prior periods.

Hence the cash forecast has a most beneficial influence in the forward planning of the purchasing program. Properly used, it enables management to foresee the need and test the availability of short terms loans or other sources of funds. It also makes it possible to calculate the duration of loans and thereby to negotiate the most suitable and favourable financing arrangements. It transpires that the purchasing program must be modified, this fact is made clear at a sufficiently early stage to allow the adjustment to be made at the least cost to the business.

Implications of Labour Costs

Of equal and often greater importance than the purchasing program are the financial implications of the labour bill. Modern techniques of forward planning are designed to enable a manufacturing company to make the best possible working arrangements for its labour force. While any production program must be kept sufficiently fluid to adapt to unforeseen market conditions, the basic concept will be to maintain a steady flow of work in regular hours. Apart from the highly desirable results forthcoming from a congenial working atmosphere created by a level flow of work, important savings are obtainable when production is turned out by experienced hands and when overtime, training and other penalty costs are kept to a minimum. For this reason, the cash payout for wages may follow a different trend from cash receipts, although both factors are, in the long run, based on the sales projection. Here again the cash forecast fulfils a vital function in providing advance warning of any pressure on the cash resources which might arise from this situation.

The preparation of the payroll section of the cash forecast is worthy of considerable research. The amounts involved are usually large and care must be taken to achieve a high degree of accuracy. Since the payroll takes time to prepare, the net wages will usually become payable several days after the end of the work week or period. This time lag may cause disproportionately high or low cash requirements in certain months. The payment pattern of the various payroll deductions and fringe benefits also requires careful study. For example, the funding agreement of pension plans may be sufficiently flexible that the business can make payments at times in the year best suited to its cash position.

Effect of Other Items

Observations made on the cash forecasting of sales, purchased materials and wage payrolls apply in varying degrees to the many other items which are involved in the for-

ward planning of business operations. Business practice has caused many expenses to be incurred and paid for at times in the year which are not logically coordinated with either the needs of the business or its cash position and frequently without any benefits in the form of reduced prices. Sometimes various supplies are carried in stock which are available at the same price on an immediate delivery basis. Perhaps the premiums of insurance policies fall due at times which are inconvenient to the cash position of the company. Stationery, office and many plant supplies may be bought in quantity in, say, January because it has become a habit to let the stock run low at the end of the year, regardless of the fact that January might be an awkward month for meeting cash payments. Ideally, the manner in which the expense budget is incurred and paid for should be arranged, as far as possible, to suit the trends of the cash position.

Capital Expenditure Estimates

When the receipts and disbursements arising from the trading activities of the business have been plotted on the cash forecast, attention can be turned to the demands which will be imposed on the cash position by the capital expenditure estimates. The accelerated pace of modern business creates high obsolescence not only of tools, machinery and buildings but also of the geographical suitability of entire manufacturing plants. In the past ten years, the size and frequency of these expenditures has become a matter of major concern to most aggressive companies. While the operating budgets will reflect consequent increases in the depreciation and other amortization costs, the charges are nevertheless spread in the budget over a term of several fiscal periods. The cash forecast, on the other hand, must make provision for the entire outlays involved in new manufacturing facilities on, or close to, the dates of their acquisition. The function of the cash forecast is most important in equating this type of anticipated cash burden with future sources of funds.

The rise in industrial expansion generally has created a wide variety of competitive sources and methods of long term financing. Business can now come closer than ever to a financing plan tailored to its individual needs, although it may find the money market more selective.

Highly topical in business and economic circles, at the present time, is the so-called "tight" money market. The government action which generated this situation was intended to curb inflation. Certain businesses were bound to experience a downward trend in their sales, and to recognize the need to cut back on their purchasing programs and to defer plans for major plant extensions. The impact on business of the tight money policy is severe and somewhat typical of the volatile forces with which modern business is continually preoccupied. With the use of modern techniques of cash forecasting, it is possible to make a thorough survey of the sources from which cash will flow into the business, to consider the possible effect which various economic forces may have on this flow and to determine a relationship between short term and long term financing arrangements which is best suited to safeguard the interests of the particular business.

Financial Control of Ontario Municipalities

PAUL HICKEY

IN ONTARIO there are approximately 970 cities, towns, villages and townships. In addition, there are tens of thousands of boards and commissions which have been delegated, either by the legislature itself or by the council of the municipality concerned, such local government functions as elementary and secondary education; the distribution of hydro electric energy; the management of parks, libraries, cemeteries and public hospitals; the administration of police protection, public health services, public welfare, and the control of land use.

To understand the framework which underlies this vast network, we must first examine the legal relationships of the municipalities to the Government of Canada and the Province of Ontario and then develop the organizational structure of the average urban Ontario municipality. Because, however, the law is voluminous and complex, it is possible to indicate only in a general way the restrictions which it places on the municipalities.

Relations with Federal Government

Since the municipalities are creatures of the province, their relationships with the Government of Canada must be provided for in the provincial statutes. Historically, these relationships have been few. However, in recent years, with the increasing pressure for federal participation in governmental activities, their number has increased.

The following major financial relationships exist between some municipalities and the Canadian Government:

1. Lands or properties of the Government of Canada are exempted from municipal taxation by the Ontario Assessment Act. The result is that the municipalities have had to provide services to such properties without compensation. In partial recognition of this inequality, the federal government has recently taken the following steps:
   (a) Payments in lieu of taxes are made to a municipality in which federal properties are particularly concentrated. Only a few municipalities, however, benefit from this provision.
   (b) Payments in lieu of taxes are made to a municipality in order to relieve a tenant or

user of land owned by the Crown from his personal liability to pay municipal taxes levied against him. This situation has arisen because of a Supreme Court of Canada decision stating that such tenants or users are personally liable for municipal taxes. The provision merely relieves the municipality of the problem of collection but does not represent additional revenue to it.

2. Many of the larger urban municipalities have participated with the Government of Canada in the assembly of serviced land and in the construction of public housing projects. Usually the cost of such projects is financed by the federal, provincial and municipal governments in the ratio of 75%, 17½% and 7½%. These projects carry varying degrees of municipal subsidization.
3. Through the medium of the Grade Crossing Fund, administered by the Board of Transport Commissioners, the Government of Canada contributes towards the elimination of railway grade crossings. These contributions are at the rate of 60% of the cost, with a maximum of $300,000 for any one project.
4. Although the municipalities do not participate directly in the federal health program, they receive subsidies on certain specific projects indirectly through the provincial Department of Health.

Relations with Province of Ontario

The financial policies of the legislature with regard to municipal institutions are administered mainly by two agencies, the Department of Municipal Affairs and the Ontario Municipal Board. The former is a department of the government headed by a Minister of the Crown. Its chief activities are municipal bookkeeping and accounting, the assembly of financial information concerning the municipalities, auditing of municipal accounts, improvement of municipal administration techniques and procedures, and payment of subsidies. The Ontario Municipal Board is charged with administering the Ontario Municipal Board Act, which states that a municipality shall not pass any by-law to authorize the construction of, or the provision of moneys for, any undertaking, the cost of which in whole or in part is to be raised in a subsequent year or years. Under the terms of this statute the province exercises direct control over the amount of the debenture debt incurred by a municipality. This law imposes a heavy administrative burden because the municipalities' capital expenditure program must be designed so as to secure the Ontario Municipal Board's approval before beginning any project which is to be financed from the proceeds of a debenture issue.

The responsibilities of a number of provincial departments include the administration of certain Acts which restrict, either on a partial or a complete basis, the expenditure of funds by the municipalities. For example, proposed municipal expenditures on roadway construction and maintenance are subject to the approval of the Department of Highways if the expenditures are to be subsidized; proposed expenditures on sewerage and water systems must be approved by the Sanitation Division of the pro-

vincial Department of Health; school construction must be approved by the Department of Education. Similar relationships exist with the Departments of Public Welfare, Attorney-General, Planning and Development, Reform Institutions and the Hydro Electric Power Commission.

Boards and Commissions

The number, size and importance of boards and commissions vary among municipalities. Generally speaking, the larger the municipality, the greater is the tendency for the council to delegate functions to boards and commissions. Because of varying local opinions and conditions concerning a particular problem, each municipality evolves its own pattern. For instance, in Toronto, the administration of parks and park lands is assumed by a committee of the council, whereas in Hamilton this responsibility has been delegated to a Board of Park Management.

Some boards and commissions, such as boards of education, are independent of council. The council must levy, against the proper panel of school supporters, according to the requisitions presented to it by the board of education. In the case of capital moneys, council may require that a particular project secure an affirmative vote of the electors before advancing the sum requested. The financial structure of the hydro electric commissions is controlled by the Hydro Electric Power Commission of Ontario. If a local hydro commission requires capital moneys, such moneys are borrowed by the municipality on its behalf.

Some boards, created by council, operate under provincial Acts which give them limited rights to demand that council levy a minimum sum on their behalf. Boards of park management and public library boards are examples of this type. Other boards, despite the extensive authority in certain local government functions delegated to them by the legislature, do not have final control over the spending of moneys. Examples of this kind are cemetery boards, boards of commissioners of police, boards of health, planning boards and public hospital boards.

Municipal Functions

The residue of municipal functions, which have not been delegated out, may be divided into two types: those of a major operational nature which are conducted under a departmental head within the supervision of a committee of council, and those which do not report to a specific council committee. Here again each municipality has developed its own framework. Hamilton, for instance, has set up the following committees of council: the Works Committee (construction of roadways and sidewalks and construction and maintenance of sewerage and water systems), the Streets and Sanitation Committee (maintenance of streets and sidewalks and collection and disposal of garbage), Fire and Jail Committee (fire protection and operation of the jail).

Financial Structure

Final control of the financial structure of a municipality rests with its council. In the larger municipalities of the province, it is exercised to a great extent by a committee of council called a board of control. This board is composed of the mayor

and four controllers, whose duty it shall be "to prepare estimates of the proposed expenditures for the year, to prepare specifications for and award all contracts, to nominate to the council all heads of departments and sub-departments, to recommend the salaries of all officers and clerks". The importance of this board is indicated in the Municipal Act which provides that, generally speaking, council may not reverse the board's actions without a two-thirds vote.

The chief financial officer and adviser to the municipality is the treasurer. He is responsible for the installation and operation of the system of accounts; proper receipt and disbursement of all moneys; preparation of monthly, annual and special financial statements; preparation and presentation of the annual estimates; and enforcement of the estimates after they have been approved by council. He must be extremely familiar with those sections of the statutes dealing with the receipt and expenditures of moneys. A salient feature of these statutes is that the municipality derives its powers exclusively from the province and may assume only those responsibilities and activities for which specific provision exists in one of the public acts or private bills of the Ontario legislature.

Municipal Expenditures

Municipal expenditures with the sums spent on them may be classified under the following headings — services to property, health and welfare activities, and education or cultural activities. For purposes of illustration, reference is made to the accounts of the Corporation of the City of Hamilton for the year ended December 31, 1955.

Function	*Amount*	
Services to Property		
Police and fire protection	3,598,167	
Construction, repairing, cleaning, flushing, and removal of snow on roadways and sidewalks	2,675,957	
Construction, maintenance and operation of sewerage system	1,652,824	
Collection of garbage	508,269	
Street lighting	315,893	
Traffic control and on- and off-street, parking	303,982	
Inspection of the construction of buildings	118,467	
Control of land use	74,640	
Smoke abatement	18,165	
	9,266,364	38%
Health and Welfare		
Operating deficit of a public hospital	1,154,289	
Parks, playgrounds and recreational facilities	818,979	
Hospitalization of indigents	561,861	
Public assistance	516,540	
Public health	463,173	
Administration of justice	395,468	
Statutory contributions to Children's Aid Societies and other related organizations in the child welfare field	359,564	
Grants to privately operated health and welfare agencies	169,781	
Homes for the aged	165,698	
Cemeteries	43,658	
Public housing	28,636	
	4,677,647	20%
Educational and Cultural		
Elementary and secondary education	7,577,266	
Libraries	301,288	
University education	98,597	
Art gallery and scholarships	20,850	
	7,998,001	33%

General Municipal		
Assessing, finance, purchasing, legal, employee benefits and administration costs	1,644,046	
Unclassified	418,623	
Provision for reserves	131,175	
	2,193,844	9%
	24,135,856	100%

This analysis reflects the cost of education, public hospitals, parks, libraries, cemeteries and homes for the aged on the basis of the net requirement from the general funds of the municipality.

Municipal Revenues

The major municipal revenue in Ontario is a tax on all real property in the ratio which the assessment of each property bears to the total assessment. In the interest of fair and equitable taxation it is essential that the property assessments be prepared in a realistic and consistent manner. The basis of assessment is outlined in the Assessment Act, but the actual mechanics used are substantially at the discretion and judgment of the assessment commissioner.

Revenue received from the imposition of a business tax is substantial. In Ontario this tax was introduced many years ago to replace the personal property tax and is assessed as a personal tax. The amount is determined as a percentage of the real property assessment applicable to the particular property occupied by the taxpayer who is subject to the business tax. This percentage varies according to the occupation of the taxpayer involved.

The municipalities of the province receive large sums annually in the form of provincial subsidies. The bases for determining the amounts of these subsidies may be a percentage of certain specified subsidizable costs, an amount per capita or an amount depending on taxable assessment percentages.

The balance of the revenues is derived from such items as licences, fines, fees and utility earnings. Again for the purposes of illustration, here is an analysis of the revenues of the City of Hamilton for the year ended December 31, 1955:

Revenues	*Amount*	%
Real property taxes	17,111,523	70
Business taxes	2,956,432	12
Local improvement and other charges	654,480	3
Payments in lieu of taxes — federal, provincial, municipal	279,549	1
Provincial subsidies	1,622,917	7
Licences, fines and fees	1,032,185	4
Earnings from municipal utilities — waterworks	335,414	1
Other revenues	445,625	2
	24,438,125	100%

The Estimates

The above program is controlled by the development, preparation, legislative approval and subsequent enforcement of a budget, which is referred to in the statutes of the province as "the estimates". The Municipal Act requires that "the council of every municipality prepare and adopt estimates of all sums required during the year for the purposes of the municipality".

Preparing the annual estimates in a large municipality is a formidable task. A well-qualified and experienced accounting staff, with a thorough knowledge of the operating and ad-

ministrative departments and the boards and commissions, is needed to integrate the overall municipal requirement. They must discuss the past experiences and the future plans of these agencies with the department heads and the senior staff involved, prepare a vast amount of data on personal and contractual services and attend special sub-committee meetings, as well as formal committee meetings on estimates. A substantial amount of study and research is necessary before the preliminary estimates are assembled and the treasurer guides these estimates through the board of control and council. Upon the completion of this process, the treasurer is in possession of a document which outlines the municipality's spending program for the current year as well as its financial commitments to the boards and commissions. Subsequently, one of his tasks is to satisfy himself that all expenditures of the current fund have been provided for in the estimates.

Capital Budget

In addition to the annual estimates, passed to control current operations, it is essential that a large rapidly-developing municipality adopt a comparatively new technique referred to as a "capital budget". This budget controls the obligations which the municipality incurs by assuming additional debenture debt. For instance, in the City of Hamilton, within the next five years it is contemplated that funds will be needed for the construction of a city hall and a joint court house, major extensions to the water filtration and sewage disposal facilities, provision of additional public hospital facilities, erection of a startling number of elementary and secondary schools and a vast number of sewer, sidewalk, roadway and other municipal projects. The existence of an instrument of control is essential (a) to keep the amount of debenture principal and interest payments within safe limits and (b) to develop an order of priority and a system of works allocation.

A capital budget has been defined as a long term improvement program plus a coordinated outline of the methods by which the improvement program is to be financed. The preparation of a capital budget requires that all departments, boards and commissions be consulted, that extensive discussions be held to permit each unit to submit a tentative list of possible capital requirements. Preliminary decisions must be extensively reviewed by a capital budget committee, which is generally made up of the chief financial, engineering and planning officers with a representative from the legislative branch. The financial implications of the program must be exhaustively studied in order to appraise the ability of the municipality to meet the resulting debenture principal and interest payments. As the result of this study, further changes are usually made by the committee before presentation to the legislative branch, which in Hamilton is the board of control. This board holds many meetings before the program is finally accepted and recommended to council.

In conclusion, it might be said that the key to the control of the financial structure of a municipality lies in the preparation of a sound annual budget and strict enforcement of that budget, the successful collection of the real property and business taxes and in the development and administration of a realistic capital budget program.

Capital for Small Business

W. S. HULTON

". . . , on the whole, managements do not worry over capital supply until the financial shoe pinches. Then it is often too late to do a good job".[1]

FAILURE TO MAKE long range plans for capital requirements is not peculiar to small companies, but because of their lack of experience financial planning it is often a problem to them. The usual hindrance to their national growth is a shortage of cash.

What is a Small Company?

The Small Business Administration in the United States defines a small business as one which is independently owned and operated and not dominant in its field. This definition covers companies in which the owners are either members of a family or friends and are themselves the managers. The owners have supplied all the capital because they have not yet been able to go to the public to sell stock.

This definition avoids using tricky yardsticks such as number of employees (e.g. less than 500) or amount of turnover (e.g. less than $1 million) which varies among industries. When examining the need for financial aid, however, it is reasonable to go a stage further and say that a small company is one with net worth in the range of $25,000 to $500,000. Below $25,000, it will probably be a one-man operation. Above $500,000, it will likely be in the public company class.

Whatever the definition, at least 90% of all companies in Canada, as in the U.K. and the U.S.A., may be classified as small and their continued existence is important to the well-being of the country. Although overshadowed by the industrial giants, they are an integral part of commercial life and provide a much needed competitive element. They should therefore be preserved and assisted to develop, if they are worthwhile.

According to Dun and Bradstreet reports, small business failures run high, and 90% of them are due to inexperience or incompetence of the management. While outside factors such as technical changes or new competitive situations may cause difficulties, it is lack of managerial ability that is responsible for most bank-

[1] "The Practice of Management", by Peter F. Drucker.

ruptcies. Those companies which are marginal, producing an insufficient return on investment, are economic parasites preying on their neighbours and their competitors. No good is done by providing capital for them.

Many failures of small companies are directly attributable to not forecasting correctly cash requirements for an increase in output or a program of capital expansion. Others arise from too slow reaction to changed circumstances. It is not uncommon today to find companies needing more capital, and many companies are over-trading seriously on their present capital resources.

Shortages of capital are created by:—

1. Taxation

(a) Corporation income taxes make it difficult and sometimes impossible to finance from within the expansion of a business.

(b) Personal succession duties put a brake on development of a business following the death of its owner.

2. Inflation

(a) Rising prices make it more difficult to finance today even the same volume of sales as yesterday.

(b) Old equipment is replaced by new machines at prices bearing little or no relationship to the book value of the old assets.

(c) Everyone is eager to expand in a period of prosperity.

During 1956 the Bank of Canada initiated policies designed to slow down inflationary movements. Capital has become harder and more expensive to obtain. More than ever before, capital requirements should be kept to a minimum consistent with healthy trading. The economic and efficient use of capital, both working and fixed, should be scrutinized. There is a need for careful study of what does go on and clear thinking as to what ought to go on, the two not always being identical.

Why is More Money Needed?

If there is a shortage of cash, additional funds may be made available internally by speeding up the circulation of working capital, for example, by collecting receivables more quickly, by realizing part of the inventories, by delaying orders for raw materials, by reducing the amount of work in process on the floor at any time, and by selling redundant or uneconomical assets.

If, however, all the internal resources, i.e. men, materials, machines and money, are being used most effectively and economically, and this is still insufficient to generate the required funds, then external funds will be needed.

New money may be required for one or more of the following purposes:—

1. To purchase additional equipment or to replace existing machines.
2. To finance a higher sales volume or to meet rising costs on the present sales volume.
3. To pay off accumulated debts.
4. To meet the demands of seasonal trade by financing a temporary increase in raw materials.
5. To make an exceptional payment under a guarantee or against a legal claim.
6. To anticipate an issue of capital, the amount of which has yet to be determined.

Normally temporary or short term finance should be obtained for self-

adjusting or non-recurring items and also if the financial position is unsettled. Permanent or long term capital should be obtained for new fixed assets or additional working capital and to acquire new businesses.

Since problems vary among businesses, there is no set formula to guide an owner to a correct solution for his business. However, when there is a chance to raise permanent capital it generally pays to raise it, even if, on a short view, temporary finance may look cheaper.

Sources of New Money

1. TEMPORARY FINANCE

(a) *Bank Credit*

A bank overdraft or loan is always the cheapest and, being flexible, the most convenient way to finance current transactions. It ought to be used for this purpose, not for the purchase of fixed assets. Moreover, it is unwise to turn what ought to be a fluctuating credit into a hard core that cannot be repaid within a reasonable term out of earnings. In the post war years of boom conditions and low interest rates there was always a temptation for both bank customers and bankers themselves to do this. Now that there is a shift to the wintry season of credit restriction, a company that has either over-borrowed or borrowed for purposes for which bank finance was never designed may easily be in fatal trouble.

As in all business matters, this is largely a question of avoiding extremes. Not to borrow for legitimate purposes is nearly as stupid as over-borrowing. The credit squeeze is on and money is tight, but credit is still available for sound and properly managed companies. Credit worthiness, not size, determines the bank loan. An American banker said recently "We've got a vault full of money. Small business has the wheelbarrow and, whatever it is entitled to, we lend."

(b) *Instalment finance and equipment leasing*

On the average, these will cost two or three times more than bank credit. They are useful and proper sources of finance, especially for the small company, and merit their current wide use for automobiles and equipment. Once again the moral is to avoid extremes.

(c) *Trade credit*

Some companies secure temporary finance by deliberately holding up the payment of suppliers. This method has the superficial attraction of cheapness because it is interest-free. However, it not only tends to do long term damage to a company's credit status but also results in suppliers calling the tune on deliveries, so that in the long run any business using this form of finance pays dearly. The prompt payer gains more than the very valuable cash discounts he earns, while the slow payer, even if reliable, is made to pay in some way for the credit he takes.

2. PERMANENT CAPITAL

The largest sources are retained earnings and depreciation. Lucky is the business which manages to retain enough to keep pace with the constantly expanding financial requirements arising from inflation. Taxes now eat up earnings which used to be hoarded for expansion. Capital cost allowances are related to historical costs but

fixed assets have to be replaced at current costs. Dividend policy may be conservative but an investor must receive a proper return on his money.

Consequently a business may need to have recourse to one of these outside sources:—

(a) *Interested parties, such as friends, employees, suppliers, customers, etc*

Personal friends, if they have the funds, may be interested, but difficulties may arise on account of personal taxation. Also, succession duties may reverse the trend by forcing major shareholders to realize holdings rather than increase them.

Senior employees may be able to play a part (paying for shares by instalments) and so benefit the company by the incentive provided.

Investments by suppliers and even customers have the advantage of establishing continuous trading relationships, so long as individual holdings are insignificant and a new investor is not given undue influence.

(b) *Mortgages on property and lease-back sales*

Providing general purpose property is modern and well-sited, upto perhaps 65% of its current value may be mortgaged at a reasonable rate of interest. Such a mortgage may be held by an insurance company or a local individual. (Lawyers have private clients and trust companies have estate funds with moneys to invest).

If the requirement cannot be met by a mortgage, it may be necessary to sell the property and lease it back on a long term basis. This releases the full value and creates no charge. It is possible to take an option to repurchase at the end of the lease, but before doing so, legal and accounting advice should be obtained because of possible tax disadvantages. Also, a company should be confident that inflation has run its course before signing the contract and handing over a possible long term capital gain on property value for short term benefits, if other methods of obtaining capital are available. Other snags in leasebacks are the need to find new premises at the end of the lease, the sacrifice of improvements made during the lease, full liability for repairs and weakening of the asset position of the company.

(c) *Public issues*

Unlisted stocks are viewed with disfavour by investment trusts and other institutions. Because insurance companies and pension funds have specific obligations, care and prudence must be the watchwords of their investment managers. Consequently they stick to fixed term capital, and when they do venture into common stocks they tend toward "blue chips" only.

An issue by prospectus is apt to be expensive for a small company, both in the commissions paid to investment dealers and in the surrendering of bonus shares which may be required to sweeten the package of bonds or other senior securities.

(d) *Specialist institutions*

If the business is well established and progressive, a likely source of new capital may be one of the institutions created in recent years

to specialize in direct financing of small industrial companies. This kind of institution will subscribe common shares if there is a growth potential that should one day make the shares ripe for stock exchange marketing. It may also provide means for disposal of existing stock where the owners want cash for succession duty purposes.

A new or nearly new business can only expect to succeed in tapping these sources if it possesses unusual attractions which will stand up under searching and expert examination. The use of other people's money cannot be obtained without offering the prospect the reward of a good profit in accordance with the amount of risk taken.

Small companies often fight shy of seeking institutional aid, fearing interference in management and perhaps eventual loss of voting control. In practice this is seldom proved correct. An institution holding a block of redeemable preference shares or debentures is unlikely to jeopardize a company's position by enforcing redemption provisions unless the company's management proves to be inept. It may wish, however, to nominate a director to watch over its investment.

The Form New Money Should Take

Most businesses possess individual features and a suitable capital structure has to be designed to fit these. The average industrialist needs expert advice, which is given willingly and in the first instance costs nothing. Nevertheless, certain generalizations are possible.

The importance of the relationship of various classes of borrowed and share capital to one another is often ignored. The desire to retain voting control while at the same time providing only a comparatively small percentage of the total capital is noticeable especially in small companies. High leverage has also increased in recent years. This is due to the high level of taxation which favours borrowed capital with interest payments allowable as a charge in preference to share capital with dividends due from taxed earnings.

A balanced capital structure is probably more important for a growing business than the owners' natural desire to hang onto control as long as possible. It is as vital to any business as its production layout and should not be sacrificed to secure a transient tax advantage.

However carefully a budget is drawn up, new plant projects have a habit of costing more than was estimated, and sometimes new sales developments prove to be even better than expected. It is necessary to consider where the next slice of capital is going to fit into the cake. Whereas the private investor may have used up all his resources and be a stumbling block if he holds bonds with restrictive rights, the professional investor with wider experience is more accustomed to following his money and putting up a second dollar to work with his first dollar.

One should be careful lest indebtedness in one direction restricts necessary credit in another. It is a good idea to leave some major asset uncharged to use as a pledge in an emergency.

Risk capital or equity is the life blood of any business and should provide about 50% of its requirements. Ideally not more than 30% should be

in borrowed capital. After assessing the future maintainable profits of a business one should not assume fixed obligations, including preference dividends, which will require more than half of the earnings. For example, it may be better to offer common shares, perhaps in A class non-voting but otherwise ranking equally with the B class voting, rather than preferred shares which are not really suitable for particular investors or for the company.

The best advice on capital structure is to keep it simple; shares with curious provisions are usually the subject of future regret.

Information for the Investor

The seeker of capital should come armed with all available information to answer questions and make a complete disclosure of all relevant facts, as what he says or does not say is revealing. Apart from full details of the financial requirements, he should be ready to give a brief history of the business, names of shareholders and their holdings, the qualifications and experience of executives, a description of the products with copies of brochures and price lists, list of customers, list of competitors, copies of the latest audited accounts, summary of profits over past few years, trend of sales over recent years, list of large orders in hand and budget for current year's operations.

All of this may seem like hard work, but when asking for money the onus of proof is on the borrower. The lender is anxious to lend, but he wants to know all about the company and the people in it. As an outside investor he cannot be expert in every industry.

The small businessman requires able guidance at all times. He is not likely to go wrong if he makes his banker his first confidant, for the banker is usually familiar to some extent with the business. Then he should seek professional advice early from his accountant and lawyer and establish a good connection with an investment house known to have experience in dealing with the problems of small companies.

Negotiations take time. A request for cash at short notice is often a sign of poor management. The financial budget should be prepared with care, and plans of how to seek needed financial aid should always be ready.

A potential investor will be influenced considerably by the way in which a business is being operated before the request for aid is made. The seeker of capital should not do things which may make the investor wonder whether the same tactics will be followed when he is a partner.

What Part Can the Accountant Play?

An accountant will frequently be called in for advice. With his personal knowledge of directors, officers, suppliers, customers, etc. he is in a unique position to suggest a source of funds and review the arrangements, prepare statements, determine prices and anticipate tax problems.

The auditor cannot assume full responsibility for such guidance, but he should know when to suggest consulting other experts – in this instance, when to obtain the services of an investment house. When his client seeks outside financial assistance he will often go along with him and for the best results in the shortest time should have all the information available for presentation at once

in clear and concise form. Successfully conducted negotiations reflect favourably on the accounting firm and may be a source of future accounting work.

The accountant has an opportunity to educate clients who may have relatively little managerial experience. It is easy to enter a small business with little or no capital, but an outside institution is reluctant to risk its money if the owner has very little of his at stake. Applicants who are too thin on the equity side are likely to be turned down.

Role of Management

There is no black magic about the raising of capital. Promising companies are still ruined by faulty capitalizations and wrong financial policies, but this only emphasizes the need for advice from a reputable investment house. If it cannot help, it will probably suggest someone who can.

The technique of long term financing for small business is still in its infancy. What is right for large companies is not necessarily suitable for small companies. The managerial strength of a private company has not the long term stability of a public company. Its small size precludes the building up of management teams at various age levels.

Good management does not only lie in energetic salesmanship or efficient production but in the correlation of all activities. A company has to show itself worthy of an outside partner; anyone who is asked for money will need convincing that his investment is sound. In the eyes of the experienced professional investor the best security for an investment is not a bond or a debenture but confidence in the ability and integrity of the company's management. As small business will probably have to rely more and more on capital from outside investors in the future, it should strengthen its managerial techniques.

To meet their need for more capital, owners of small companies should prepare and negotiate schemes early rather than late, assess and explain the risks to be run as well as the prizes to be won, and distinguish between credit and capital.

If the seeker of capital meets each particular provider of capital on common ground, with some understanding of what is or is not reasonable to ask from him, his outstanding financial problems will be quickly and satisfactorily solved.

Accounting for Plant Shutdowns

HARRY M. BELYEA

MOST MANUFACTURING businesses face the perennial problem of significant overhead and profit variances in times of plant shut-down for vacations. In the past, the attitude has been that during the month of the plant shut-down, there will probably be little or no profit, or even a loss, and that the overhead rates will be excessive in relation to the other months of the year. Great strides have been taken in systems to account for accrued expenses, prorations of annual expenses over individual months, provision for vacation pay so that the cost of vacations is distributed equally over the year, but rarely is any provision made to look after the fixed plant overhead, administration, and financial costs that occur during the period, usually two weeks, of a complete plant shut-down.

Here is a system whereby all factors contributing to these variances are provided for throughout the rest of the year, so that the low activity of both labour and sales during the shut-down period will be recognized as such, and overhead, administration, and other charges assessed accordingly. This can be done without interfering with the company's annual statements at the end of its fiscal year.

Usually, the plant shut-down is in the month of July, and if it is a complete shut-down, there will be no direct labour or sales. Hence the totals of labour and sales for July will reflect only the totals for the remaining two weeks, whereas the overhead and other outlays to a large degree will be those of a normal operating month. An example will illustrate the problem. Assume in a manufacturing business the following:

Normal Monthly Factors

1) Direct labour	$40,000
2) Plant overhead	
— fixed	22,000
— variable with direct labour	22,000
3) Sales	220,000
4) Cost of sales (including overhead)	165,000
5) General administrative expenses	22,000
6) Financial expenses	5,500

Assume further that there are 22 working days in the plant shut-down month and that the company is working a five day week.

The amount of fixed overhead which would have normally been charged in the two week shut-down period, but which should be reflected

in the remaining 11½ months, is $10,000 (10/22 of $22,000). As this fixed overhead of $10,000 must be provided for in the remaining 11½ months, on the basis of $870 per month, it therefore follows that for 11 months of the year, the overhead would be $44,870 per month. The overhead for the one month during which the plant shut-down takes place would be $24,430 (12/22 of $44,000 plus ½ of $870), making a total annual overhead of $518,000. On the standard basis the annual overhead would have been $44,000 x 11 = $484,000 + $34,000 for the month of the shut-down (fixed $22,000 + 12/22 of variable $22,000).

A similar adjustment would have to be made to accrue general administrative expenses and financial expenses. In the example given, this would amount to a monthly provision of $870 for general administration in each of the 11½ normal months, to look after a deferral of $10,000 in the plant shut-down month, and a monthly accrual of $218 for financial expense to look after the deferral of $2,500 (both of these amounts are arrived at by taking 10/22 of the normal monthly expense).

The effect of these adjustments to the profit and loss would be as outlined below. This statement also shows the change in the percentage of gross and net profit to sales.

These comparative methods show the wide variance in the profit and loss statement in the shut-down month and the smaller variance in the other 11 months. The net effect is to shift $9,570 overhead, $9,570 general administration and $2,395 finance expenses, or a total of $21,535, from the plant shut-down month to the rest of the year, and to maintain a static margin rate, overhead rate,

	With no provision for shutdown variance		*Provision for shutdown variance*	
	1 month normal	*Plant shut-down month*	*1 month normal*	*Plant shut-down month*
Sales	220,000	120,000	220,000	120,000
Cost	164,130	99,570	165,000	90,000
Gross margin	55,870	20,430	55,000	30,000
Percentage	25.4%	17.0%	25%	25%
General administration	22,000	22,000	22,870	12,430
	33,870	(1,570)	32,130	17,570
Finance	5,500	5,500	5,718	3,105
Net profit before taxes	28,370	(7,070)	26,412	14,465
Percentage	12.9%	(5.8%)	12%	12%
Calculation of annual net profit:				
		$28,370 x 11		$26,412 x 11
		= 312,070		= 290,535
		− 7,070		+ 14,465
Total net profit (annual)		305,000		305,000

and percent of net profit to proportionate sales and production volume.

Note how this would effect a change in the comparative overhead rate by months. On the basis of no provision for plant shut-down, the overhead rate would be 110% ($44,000/$40,000 (overhead/labour)) for 11 months of the year, and 155% ($34,000/$21,816) one month of the year. On the basis of providing for the variance in normal months, the overhead rate would be 112% in all months of the year — for 11 months ($44,870/$40,000) and for the 12th month ($24,430/$21,816). This eliminates a rate variance in that month.

To prevent an adjustment of this type from affecting the company's financial year end position, by not stating the exact balance sheet condition as at that date, it is necessary to start providing for this variance monthly immediately after a fiscal year end. For example, if a company's year end is March 31 and the plant closes in July, it would be necessary to accrue monthly in April, May and June. Using the same example the accruals would be:

Plant overhead	$870
General administration	870
Finance expense	218

In July it would be necessary to defer plant overhead $9,570, general administration $9,570, and finance expense $2,395. The same accruals as made in April, May and June would also be made from September to March 31, so that at the end of the year the accrual account would be wiped out.

This method enables management to strive for the same target for margin rates, net profit percentage, and overhead rates. The performance of these factors could then be better judged by the particular volume of sales or labour activity in the period under review, rather than be clouded by the fact that during this period there was an unproductive time when, however, substantial fixed costs occurred as usual.

This same theory could be applied to an extended plant shut-down for other reasons, even to statutory holidays. Where a company is accounting on a year divided into 4-week periods (as a number of manufacturing companies now do), the system is still more effective. Ideally, by combining the concept of the 13 periods with the above method of providing for plant close-down costs, management could establish a standard target figure for overhead and profit percentages, which could be used for 50 weeks of the year. It would then be in a much stronger position to gauge efficiency of departmental costs, decide upon profit margins, draw up factual monthly budgets, and establish break-even points for sales volume.

How the Federal Tax Department Operates

H. F. HERBERT

MOST CANADIAN accountants, whether in public practice, business, or industry, have more than a passing familiarity with income tax matters through their activities on behalf of their clients and employers. Probably, however, they have a good deal scanter knowledge of the administrative machinery of the Taxation Division of the Federal Government.

Organization

Not a complex organization, the Division consists of only two levels: the management and policymaking level at head office and the operating level at the 29 districts. It has been designed and operates as a highly decentralized organization with the direct line of authority running from the Deputy Minister and his assistant to the district directors. All possible autonomy is given to district offices to decide income tax and succession duty cases in their respective areas, and it is believed that this approach is most satisfactory to taxpayers, despite some problems of uniformity. Certainly it permits the heavy volume of annual returns to be disposed of more efficiently than would be the case if each one had to be referred to a central office.

Students of organization might question the very wide span of control from the Deputy Minister to his 29 district directors. However, the lines have been tightened by delegating some management control from the Deputy to the heads of certain head office branches, by establishing a system of internal reporting and review, and by continuous audit of all phases of district activity by the head office inspection branch.

The internal structure of both levels of the Division's organization is quite uncomplicated. Head office has five branches, each headed by a director. The legal branch acts as legal adviser to the Division and deals with its responsibilities under the law pertaining to appeals, pension funds, and charitable organizations. The assessments branch develops broad assessing programs and policies for district application, handles complex technical cases referred to it by the districts, and endeavours, by a system of reporting, review, and visitation, to secure uniform application of the tax law throughout the country. The administrative services branch is responsible for the efficient conduct of all matters concerning personnel, collections, accounting, filing, and the

procurement of forms, supplies, equipment and premises. The inspection branch periodically audits all phases of the Division's activities and reports its findings directly to the Deputy Minister. The planning and development branch is a methods group whose activities are directed to making improvements in procedures and equipment with a view to increased economy of effort and efficiency of result.

Districts are also organized on straightforward lines. Each office is headed by a director whose function is primarily managerial in character. Assisting him are three senior officials, a chief assessor who supervises all types of assessing and investigation work, a supervisor of administration who has charge of accounting, collections, files, and all internal housekeeping, and a personnel officer who assists the director in relation to all matters affecting staff and organization.

Workload

By any standards the Taxation Division operates a large-scale business. Collections exceed $2½ billion annually. This represents about 54% of the total government revenue and 59% of the tax revenue. Of the income tax portion, individuals pay something over one half, and corporations the balance. The normal annual collections from succession duties are about $65 million. Returns are received from about 5 million individuals and 72,000 corporations. Instalment accounts are maintained for some 127,000 taxpayers and ledger accounts for 210,000 employers. In 1955, cases for collection action totalled almost 700,000. To carry out its responsibilities the Division employs 6,300 regular personnel in its 30 locations. Cash costs of operation run at about $25 million a year, or roughly 1% of collections. As against this cost, using the fiscal year 1955-56 as an example, the additions to declared tax resulting from assessing activity exceeded $89 million. Some idea of how the workload factor is developing may be gained from the following:

Year	*Returns Filed*	*Staff Employed*
1937	490,000	1,214
1947	3,570,000	7,430
1956	5,090,000	6,289

The Work Cycle

The Division's work cycle in any calendar year begins much earlier than the following April 30 so familiar to taxpayers and their accountants. Throughout the year, for instance, advance tax payments from instalment payers and tax deduction remittances from employers are received and recorded. Payroll auditors are in the field to ensure compliance with the law as it governs deductions at the source. Current returns from persons leaving the country or filed on behalf of deceased persons are being dealt with. Early in August the Forms Committee at head office sits to prepare the forms for the current year. Each district submits a report and recommendations to the committee on its experience with the previous year's form. Error statistics are studied to see what can be eliminated or reduced by forms modification. Amendments to the law which affect forms are analyzed. Concurrently, other officials at head office are reviewing the procedures for processing the forms to be dealt with and each district makes a report and recommendations on this subject. When the

best possible forms have been devised and estimates of probable consumption prepared, the machinery for ordering and distributing them is set in motion. At the same time the procedures manuals are revised and distributed.

By early fall a start is made, too, on preparing the radio and television publicity campaign, or the "File Early" campaign as it is better known in the Division, which will run the following March and April.

In December of the calendar year the district offices start the planning necessary for dealing with the approaching intake of returns. Supervisory staff are selected; estimates are made of intake and of staff requirements for coping with the intake. Rosters are prepared for manning information counters and temporary information offices in centres not served by a district office; and space and equipment are allocated. These few sentences only sketch in rough outline the amount of planning effort required for the filing season, particularly in the larger districts. Meanwhile another branch of government, the Treasury Office, is gearing itself to process over 2¾ million applications for refund cheques.

With the release of forms to the public early in January, a trickle of filing commences which rises to a full flood by mid-March, then ebbs somewhat, and rises again to a peak by April 30. In February the recruitment and training of temporary employees begins, many of them ex-staff members. They are used mainly for clerical duties and for the examination of wage returns. Permanent employees are used in supervisory positions and in the processing of the more complex returns, especially those of self-employed or corporate taxpayers.

All returns are examined. For most, one look suffices. Others, particularly those based on financial records, may be earmarked for closer scrutiny and possibly an examination of records at the earliest opportunity. Some returns which are incomplete or require clarification of some point are temporarily "snagged", the taxpayers are asked for what is required, and the returns finalized. After this first examination all returns go through a "T67A" process in which a form is raised for each. These pre-numbered, carbon-loaded, continuous strip forms serve several purposes. For all returns they provide the assessment notice required by law. For refunds they provide the applications to Treasury for the issuance of cheques. For taxpayers with balances to pay they provide a request for payment, a ledger account, and a first collection reminder. In addition, other copies of the form are vouchers supporting necessary internal accounting and providing the basis for statistical sampling.

The end of May sees the "mass" of the intake disposed of. The temporary employees are released and the operating segments of the district office swing into their pre-planned programs of activity for the remainder of the cycle. The volume of accounts for collection is at its peak. These accounts are subjected to the various processes of collection by means of a continuous cyclical review. The finalized returns from the T67A process have gone to the taxroll section which files them and then commences its work program of detecting non-filers and matching information re-

ceived from employers and others to that reported by taxpayers.

The assessments branch, which has been heavily involved in the T67A process, now swings fully back to its main program of examining returns and records. Some of these examinations are done on a "desk audit" basis. If the taxpayer is brought into the picture it will likely be by letter or by telephone to clarify a point. Other returns are examined on a "field audit" basis. Here the assessor goes to the taxpayer's place of business and often examines records.

Uniformity

The Division does all in its power to achieve uniformity of tax application across Canada. The problems involved will be apparent to anyone who considers that a very detailed statute must be applied to a diversity of business activity across a very wide area. To gain uniformity, the Division relies on several means of control:

1. *Manuals* — Carefully prepared policy and operating manuals are kept up-to-date for the training and guidance of all personnel engaged in enforcement and administration activities.
2. *District checking staff* — Selected assessors regularly check the completed work of all other assessors for accuracy and uniformity within the district.
3. *Head office review staff* — To achieve uniformity between districts, groups of experienced assessors are continually checking district work either by direct visit or by examination at headquarters of district office assessments. In addition, these head office personnel are consulted by the districts in difficult and complex cases.
4. *Inspection staff* — An inspection staff, responsible to the Deputy Minister, periodically examines all phases of each district's activities to ensure that laid-down procedures and policies are being effectively carried out.

Enforcement

Income taxpayers in Canada file under a system of self-assessment. In other words, they themselves state what earnings they receive and what taxes they have to pay. If all of this could be correctly accomplished in 100% of cases, the Division's role in the scheme of things could be restricted to supplying forms and information and receiving money. For several reasons, however, the Division must undertake programs of enforcement in the following three distinct fields:

1. *Taxroll field* — Some people do not file voluntarily.
2. *Assessing field* — Some returns are incorrect because of mathematical error, misinterpretation of the law, avoidance schemes and deliberate evasion.
3. *Collection field* — Some people are temporarily unable to pay taxes due or will not do so without compulsion.

In the taxroll field the enforcement effort is carried on by the taxroll sections of the district office administration branches. In addition to storing files and producing them for various purposes on requisition, they also perform a revenue-producing function. It commences immediately after the main intake of returns at April 30 has been processed and filed. A wide variety of methods is employed to detect non-filers, including checks to different kinds of directories, information reported by employers, debtors,

and dividend payers, municipal records, registries, and so on. The door-to-door canvass has been employed effectively on occasion. The steps to obtain returns from involuntary filers are the request, the demand, and the court action. In the fiscal year ended March 31, 1956, these activities produced additional returns which on assessment yielded over $7½ million in tax revenue.

It is in the assessing field that the most important of the Division's enforcement work is carried on. The aim of this work is simply to bring about maximum compliance with the tax law. The direct work is of course done by the districts along broad program and policy lines laid down by headquarters. Under the district director the chief officer responsible for assessing enforcement work is the chief assessor. Under him will be several assessing sections, the number depending upon the size of the district, a checking section, a succession duties section and a special investigation section. Sections are further broken down into groups, the number again depending upon district size. In addition, each district assessments branch has a clerical and typing unit.

As was previously mentioned, a "first look" is given returns during the T67A program. This suffices to correct mathematical errors or those due to misinterpretation of the law covering dependants, medical expense claims, and so on. The more serious kinds of tax misstatement, however, are only found by a more intensive scrutiny of returns and underlying statements and records than the "first look" technique will permit. It is in the "second look" that the main effort of assessing personnel, and especially of those trained in accountancy and special investigation methods, is employed. This type of work requires careful and intensive advance planning and programming if the most effective use is to be made of the districts' limited numbers of technical personnel.

The Division considers it an essential part of its enforcement activity to detect and punish tax evaders. Regrettably, a percentage of taxpayers cheat and thus pose a threat to their fellow citizens generally and the soundness of the tax system in particular. The detection of tax fraud is not easy and requires the use of techniques often quite different from those of ordinary assessing. Here we are in the field of criminal law with its principle of proof beyond a shadow of a doubt. The Division is always concerned with the damage possible to an honest man's credit and reputation which can result from a misdirected and clumsy investigation. Nevertheless it has been found that seemingly insignificant indications of fraud, when probed to the bottom, often lead to disclosures of extensive tax evasion.

The enforcement effort carried out in the collection field needs little explanation. It is trite to say that all the intensive taxroll and assessment effort would be of little avail if the resulting taxes assessed were not collected. Collection work is done by the accounts sections of district administration branches. It carries on steadily through the year, the peak load being received just after the April 30 filing date.

Legislation

A word should be said about the Division's role in shaping the tax law. Tax legislation is, of course, the re-

sponsibility of the Minister of Finance. The Division is asked to advise on the administrative feasibility of tax proposals. In addition, it advises the Minister of Finance of instances where the law is not operating as intended or where certain taxpayers have been able to avoid their share of the tax burden without breaking the law itself. This advisory role is in keeping with the aim already discussed whereby the Division strives for uniformity of tax application among all taxpayers.

Accounting

The Division's internal accounting system is not complex. Accounts are maintained in each district for employers who deduct tax at source, for taxpayers who make instalment payments and for those who owe assessed tax. For tax deductions, the periodic remittances from employers are credited to their tax deduction accounts. After February 28 following a calendar year a debit is posted to each such account from the employer's T4 summary return. This debit either clears the account or leaves a balance which must be immediately reconciled. Instalment payments from individual and corporate taxpayers are credited to their accounts. Debits representing assessed tax are posted after the pertinent return has been assessed. A remaining debit balance becomes subject to collection action. A credit balance is cleared by a requisition to Treasury for refund. Accounts are opened for only a small percentage of wage returns. These are cases where the deduction at source has not satisfied the full tax and the balance is not remitted on filing.

Each district office maintains a general ledger consisting mainly of control accounts for the subsidiary employers' and taxpayers' accounts, revenue accounts, and head office account.

Filing

Taxpayers' returns are stored in folders in 4-drawer file cabinets. They are maintained in straight alphabetical order, a system which has been found most satisfactory after many experiments with numeric, alpha-numeric, and library-bureau methods of indexing. A system of charge-out of requisitioned returns is maintained for file-control purposes.

Conclusion

This outline of the administration of the Taxation Division has been confined to fundamentals and is meagre of detail. A static picture could not be painted in any event. The Division, like most large Canadian business organizations today, is constantly reviewing and revising its procedures in the light of changing requirements. It must suffice to say that there is a continuing effort to maximize the efficiency of operations so that the very least part of the tax dollar collected is used up by the collection process itself.

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Shareholder Relations Programs — Interim Financial Reporting

Gertrude Mulcahy, B.A., C.A.

Public relations programs have occupied an important position in most Canadian companies in recent years. Such projects are designed by management for the specific purpose of stimulating and retaining a public demand for the company's products and services. They usually take the form of well developed regular releases pointing out the current developments and advancements made by the company in its particular field of production and in its contribution to the business world and public welfare generally.

When compared with some elaborate public relations programs in operation today, the shareholders relations program of most Canadian companies is sadly deficient. Most outstanding, perhaps, is the obvious lack of well developed regular releases which have been so predominant in public relations activities. If management expects to maintain shareholders' confidence and to cultivate investor acceptance, it may have to do something more than provide financial information once a year, at annual report time. The inadequacy of this limited disclosure, which is current practice in Canada today, is aggravated by the fact that the annual report frequently does not reach the shareholders until two to six months after the end of the fiscal year. The information it contains may well be obsolete by that time and may lead to a false impression of the current position of the shareholders' investments.

Frequent and regular reporting is a must in any well developed shareholders' relations program. The tremendous improvement in the annual reporting techniques in the last few years indicates that Canadian management has shown "that it can recognize, and is prepared to comply with, constructive changes in the needs of shareholders".[1] It is to be hoped that this recognition will not be limited to annual reporting alone but will be expanded to include regular and frequent communications during the fiscal year.

Current Developments in Interim Reporting

United States

In the United States, the practice of issuing interim reports to shareholders has become widely accepted. As in other aspects of financial reporting, the stock exchanges have played an important part in the gradual development and acceptance of this extension of reporting techniques in that country. As a general rule, the New York Stock Exchange no longer lists a company which will not agree to issue quarterly reports. Exceptions to this rule are made only for companies with peculiar inventory or accounting problems, where such reports might well prove to be misleading.

[1] F. S. Capon, *The Canadian Chartered Accountant*, October 1955.

Regular interim reporting is not a new development in the United States but has been used by an increasing number of companies since 1901. P. L. West, in an article "Progress in the Public Interest",[2] has traced the growth of this procedure among companies whose shares are listed on the New York Stock Exchange. In 1901, the newly formed United States Steel Corporation began issuing quarterly reports. The first company to agree in writing to this type of reporting was Niagara Falls Power in 1910. Mr. West points out that, as a result of the constant urgings of the Exchange, approximately 37% of the companies listed in 1927 were agreeing to quarterly reporting. This percentage rose to 63% by 1931 and 75% by 1945. By the end of November 1955, approximately 90% of the companies had agreed to adopt the practice on a quarterly basis, with an additional 7% issuing semi-annual reports.

The Securities & Exchange Commission regulations, relating to semi-annual, quarterly, and monthly reports, cover filing with the Commission only and do not require submission to shareholders. However, the semi-annual report, which consists mainly of a condensed profit and loss statement, and the monthly report of unusual transactions are available for public inspection at the offices of the Securities & Exchange Commission. They are used extensively by financial services, analysts, etc., and thus the information is widely circulated. The quarterly reports, which are made up of condensed profit and loss statements, are confidential and are used only by the Commission for statistical compilations.

[2] *The Analysts' Journal*, February 1956.

Great Britain

Leading accounting publications in Great Britain have long deplored the reluctance of British public companies to provide regular periodic reports to shareholders. Although Sir John Braithwaite, Chairman of the London Stock Exchange, has gone on record as saying that more Boards of Directors should consider issuing half-yearly statements of results, the British stock exchanges have not yet, written interim reporting into their regulations. The decision as to the adoption of this practice rests with management.

In recent years, accountants, stockbrokers and others have been putting forth considerable efforts to convince management of its responsibility to keep shareholders regularly informed, not just through annual reports but through regular reporting during the year. R. F. Tetley, in commenting on the deficiencies in current practices, pointed out that "In the interest of good relations, stockholders should be given a maximum of information as regards the progress of the company's business, whereas, in most cases, at present they are only told what the Board thinks is good for them to know and are given, once a year only, the bare minimum information laid down by the Companies Act."[3] Mr. Tetley stated further that "Even if pressure is not brought to bear by the Stock Exchange, it will be eventually by stockholders in general, who have only to combine and say they must have interim profit reports."[4]

It is encouraging to note that the efforts of those who have long advocated the more general acceptance

[3] *The Accountant*, November 1955

[4] ibid

of the practice of interim reporting have begun to produce results. In November 1956, *The Accountants Journal* noted that "More and more United Kingdom companies, though slowly and with some reluctance, are sending out progress statements." Although the numbers are not, as yet, very large, at least a start has been made toward developing this procedure into a generally accepted practice.

Canada

In Canada, as in Great Britain, there are no specific regulations requiring the communication of financial information to shareholders on other than an annual basis. Many Canadian companies, however, are affected by American interim reporting requirements either because their stocks are listed on some leading American stock exchange or because they operate as subsidiaries of American public companies. As a result, interim reporting has been used in Canada to some degree for a number of years, but there is little evidence of an outstanding trend towards the general acceptance of this procedure.

The degree to which interim reports will become common practice depends entirely on the extent to which management of Canadian companies, without American associations, come to realize that their responsibilities to keep the shareholders adequately informed cannot be accomplished through the annual report alone. In September 1956, Paul Deacon noted that, although many companies still ignore this method of communication, "The practice is growing here too, particularly in the past two or three years. Most of the leading companies have now incorporated either semi-annual or quarterly reports in their corporate agendas".[5] Mr. Deacon listed some 106 Canadian companies whose management were reporting to shareholders on a quarterly, semi-annual, or monthly basis. This represents a step in the right direction, but as there are some 900 companies whose stocks are listed on the Toronto Stock Exchange, this progress is not particularly overwhelming. In addition, according to the information provided in the *Financial Post's*, "1956 Surveys of Industrials, Mines & Oils," 29 of the companies noted by Mr. Deacon listed their stocks on either the American or New York Stock Exchange. This would indicate that to date only 77 Canadian companies have introduced interim reporting on a voluntary basis.

Of the 300 Canadian companies whose annual reports for 1956 are being included in the C.I.C.A. analysis of current financial reporting practices, only 37 had adopted the policy of issuing interim reports by December 31, 1956. Since these survey companies represent a fair cross section of Canadian industrial and commercial undertakings, this would indicate that only 12% of Canadian companies are following this most desirable procedure.

Advantages of Interim Reporting

The advantages which accrue from interim reporting by a public company are shared by the shareholders, the management and the public generally. From the shareholders' point of view the most obvious benefit lies in the fact that, through this medium of communication, they are able to keep up to date on the current trends

[5] *Financial Post*, September 29, 1956

and true position of their investments. Because of the complexities of modern business and because trends and situations in any one industry can change radically in a short period of time, this advantage is particularly important today.

Interim reports can be used by management as a means of demonstrating that it recognizes the position and rights of the shareholders as owners of the business and is accepting the responsibility of keeping them aware of actions taken in the administration of their affairs. The shareholders, in turn, are more likely to have confidence in the Board of Directors if they are assured that it is doing something more than the minimum legal requirements of annual reporting.

The frequent circulation of pertinent financial data and adequate explanations can help also to develop, among the shareholders, a better understanding of business activities and problems of management. Consequently it would be much easier for them to make an adequate assessment of the effectiveness with which the management has executed its stewardship.

The extent to which moneys can be attracted to and retained by a particular company depends upon the extent to which the investing public is convinced that the securities represent a desirable investment. If a company's performance is good, frequent and full reporting will do a great deal towards creating a receptive market for the company's securities. On the other hand, if a company's performance is unsatisfactory, interim reports containing adequate explanations and indicating the remedial action taken by management may help to prevent permanent damage to the market for the company's stocks.

Within the stock market financial information released at intervals during the fiscal year enables a more accurate valuation to be placed on shares than would otherwise be the case. "By providing authoritative information to offset rumours and to keep the shareholders closely informed on what is happening, management is helping to stabilize stock market fluctuations and to increase the marketability of securities."[6]

Alleged Disadvantages

The management of some companies have held out against interim reporting on the basis that the disclosures therein provide valuable information to competitors. This is a very out-of-date argument. The financial information included in an interim report would add very little to what the competitors can learn from other sources. American companies do not appear to have sustained any particular damage from the general acceptance of this type of disclosure.

Another objection frequently cited is that the financial information for short periods cannot possibly be exact. The preparation of quarterly figures involves estimates and assumptions concerning inventory valuations, depreciation, income tax provisions, costs of sales, bonuses and profit sharing provisions which cannot be established until the whole year's operations are taken into account. However, because of the vast improvements in accounting techniques, such estimates can be made at regular intervals during the fiscal year with a reasonable degree of accuracy. In addition, interim reports are not intend-

[6] F. S. Capon, *The Canadian Chartered Accountant*, October 1955

ed to be formal accounting documents but rather estimates prepared for the specific purposes of providing an indication of the general trend and developments. In the majority of cases, the interim reports identify the financial figures as estimates and clearly state that they have not been audited and are subject to year end audit adjustments.

It is frequently argued that seasonal fluctuations can cause the figures for any one period to be misleading. This deficiency can be very easily overcome by providing proper explanations and adequate comparative figures for earlier periods. "If each period is compared with its corresponding seasonal period in a previous year or years, the seasonal fluctuation is largely eliminated as such."[7]

[7] ibid

That the preparation and publishing of interim financial reports is too costly is no longer a valid reason for not adopting this procedure. In almost every company today, financial statements are prepared at regular intervals during the year for management's use. Thus the preparation of interim reports merely involves the releasing of information which is already available. Although some companies have used very expensive formats, a mimeographed sheet with relevant facts and figures would serve the shareholder's needs equally as well.

(This discussion will be concluded next month by an analysis of the contents of some of the interim reports prepared by Canadian companies and of other shareholder relations techniques.)

MORE ON BULLETIN NO. 10

Mr. Crowe has written a letter to the editor in regard to Mr. Herington's discussion on the subject of "Depreciation and Capital Cost Allowances" which appeared in the January issue. Because of the interest in Bulletin No. 10, Mr. Crowe accepted the suggestion that his letter should appear in this section of the magazine. We have asked Mr. Herington for any further comments he may wish to make.

Mr. Crowe Writes

Montreal, Jan. 31, 1957

BULLETIN 10

Sir: In his article on "Depreciation and Capital Cost Allowances" in your January issue, Mr. H. P. Herington dismisses my article of July 1956 on the grounds that "it is doubtful if the capital expenditures of many companies would follow a clear pattern of growth". That the factor of growth must be a consideration in any intelligent analysis can hardly be denied. Presumably, Mr. Herington means that a consistent rate of growth cannot usually be expected. If so, a re-reading of my article should convince him that a considerable portion dealt with this very problem for which, in my opinion, Bulletin 10 does not provide a satisfactory answer.

Mr. Herington states that "if, as the article suggests, Bulletin 10 only applies to a single asset it would have (a) narrow application . . . . " This is roughly correct. I consider that Bulletin 10 is based on a single asset analysis and probably makes sense for a company with a single major investment, such as one plant. Despite Mr. Herington's explanations, it has still to be demonstrated that the majority recommendation of this bulletin is a practical proposition when applied to the whole picture of a multi-asset expanding company.

Mr. Herington further states "in the long run accumulated provisions for depreciation will correspond to the aggregate capital cost allowances claimed". For a static company with one major asset this statement may be true. For a growing concern (unless the "long run" envisages the decline and winding-up of the company) it is very wide of the mark indeed. This problem has been discussed authoritatively in a number of articles, but the essential principle clearly is as follows:

For a single asset, accumulated depreciation obviously sooner or later becomes 100% of the cost of the asset. Therefore, you may say that ultimately the method or rate of depreciation doesn't much matter. Looking at the overall picture of a progressive industrial firm, however, accumulated depreciation is never likely to approach 100% of the cost of the company's assets. It is almost a contradiction in terms to think of such a company having its assets fully depreciated. Accumulated depreciation for a going concern, therefore, is normally at a level very much less than 100% (probably below 50%) of the total asset cost. This level is a function of two factors:

1) The rate of growth of the company.
2) The rate of depreciation.

The higher the rate of growth, the lower the ratio of accumulated depreciation to asset costs; the higher the rate of depreciation, the higher the ratio. Therefore, for a going expanding company the rate or method of providing for depreciation or claiming capital cost allowance makes a very great deal of difference, not only in the short run, but, more important, in the *long run*.

Mr. Herington comments that with constant tax rates "income taxes in the long run will be the same, however capital cost allowances may be taken". Again this sweeping theory, if true, might make it easier for accountants to sleep at night. For the reasons noted above and having regard for the change and growth of the Canadian economy, as evidenced for example by the Gordon Report, it is an assumption which is more than somewhat unreal.

It is my understanding that the discussions in Halifax by no means indicated "substantial acceptance of the bulletin". In fact, there was a widespread belief that the majority position should and would be re-examined. Mr. Herington's article is a narrow re-affirmation of the majority recommendation. I suggest that in the fullness of time the minority opinion will be recognized as a much shrewder appraisal of the situation.

J. W. Crowe, C.A.

Mr. Herington Replies

I welcome this opportunity of considering further some of the possible effects of Bulletin No. 10. At the outset I wish to say that Mr. Crowe's approach and in particular the kind of calculations he has made are essential to a full understanding of the subject. If in my discussion in the January issue I seemed to dismiss his article, it was not because it lacked interest or usefulness but because it did not offer a clear-cut solution for the immediate problem which is the distortion of income that occurs when income taxes are materially reduced through the application of the capital cost allowance provisions of the Income Tax Act.

Turning to the article itself, I shall begin where Mr. Crowe left off. His concluding words were "Savings accruing from the diminishing balance system unfortunately will probably not come to companies in any even flow, but will vary directly and violently with sharp fluctuations in gross construction expenditures. Where this *distortion of income* becomes a significant problem, however, it would not appear to be beyond the ingenuity of accountants to develop an answer". The italics which are mine have been introduced in order to focus attention on the situation which led to the issue of Bulletin No. 10.

Having removed these sentences from their context, I hasten to add that in the particular circumstances described in the article Mr. Crowe correctly reaches the conclusion that for any company with a positive rate of expansion there is a continuous reduction in taxes and these reduc-

tions normally represent real savings. It follows that in such cases the payment of the so-called deferred income tax is indefinitely postponed. This would also be true of initial savings where there is no appreciable expansion.

However, I hold to the view that the repeal of regulation 1100(4) and the number of cases of unprecedented expansion programs created just such a situation as that to which Mr. Crowe referred in the concluding sentences of his article. It was for these reasons that the Committee on Accounting and Auditing Research undertook a study of the problem, and the recommendations of Bulletin No. 10 were offered as a means of overcoming the difficulty.

We who were concerned with the preparation of that bulletin, recognizing the growing importance of the figure of net income for the year, first directed our attention to the income account. The introduction of a charge for income taxes calculated on the footing that the amount of the recorded depreciation and no more would be claimed as a capital cost allowance produced a figure for net income which could be usefully compared with the results of other years.

Turning then to the credit side of the entry, we became as it were the victims of double entry bookkeeping. What was the nature of this credit which emerged as "deferred income tax", a liability for income tax payable at a future date, an allocation of present and future income taxes or a permanent tax saving? These were some of the questions that required an answer.

It was suggested that a tabulation of the past experience of a selected group of companies might provide the answer. The tabulation was not proceeded with for a number of reasons. First, it was doubtful if the experience of the past would be a reliable guide to the future in this as in many other respects; secondly, unless a large number of companies, both large and small, were selected the results might not be representative; thirdly, there was no assurance that companies would cooperate to the extent necessary if the study was to be effective; and finally, the clerical effort would have been quite beyond the resources of the committee.

It may well be that for some companies the difference between recorded depreciation and capital cost allowance is merely one of those circumstances consistently present year after year which explain the disparity between reported income and taxable income. It would then be one of the many factors which produce a variable corporate tax. A company whose experience was substantially similar to that shown in table 2 of Mr. Crowe's article would undoubtedly be a company of this sort.

It may be reasonable to forecast a continuous and orderly growth for an entire economy over 15 or even 25 years. It does not follow that any one company or any one industry will enjoy a corresponding growth.

Bulletin No. 10 has already had a degree of acceptance by those companies that publish their accounts, which indicates it is serving a useful purpose. As a matter of convenience and not necessarily because of disagreement with the recommended procedure a great many companies, particularly in the medium and smaller group, have accepted capital cost allowance as a substitute for depreciation. In the absence of construction in progress this procedure does not usually lead to an undue distortion of income.

The majority position in regard to Bulletin No. 10 was re-examined following the discussions in Halifax and the appearance of Mr. Crowe's article, and there seemed to be no need for a revision of its recommendations at this time. The committee, while expressing a preference for a particular treatment, offered as an alternative a resort to explanatory notes. I would think that any company that feels that in its particular circumstances the tax savings are likely to be permanent savings is free to say so. In the meantime, Bulletin No. 10 remains on the agenda of the committee and if experience points to a better solution revision will surely come.

C.I.C.A. Research Bulletin No. 13

March 1957

STATEMENTS WITHOUT AUDIT

A PRACTISING member of the Institute is frequently engaged in his capacity as an accountant rather than as an auditor. This type of engagement may require the preparation of financial statements without examination sufficient in scope to permit an expression of opinion.

Unaudited statements may be tentative in nature, perhaps intended only for the client, but the accountant has little opportunity to control their use or to prevent them from being placed in the hands of third parties. The types of engagements are so varied that uniformity in procedures cannot be expected, but the difference between the reliance warranted by audited statements on the one hand, and the provisional nature of unaudited statements on the other hand, calls for a clear distinction if misunderstandings are to be avoided.

The following recommendations are made with a view to clarification of practice and of public understanding of the degree of responsibility resting on the accountant in specific cases. The suggestions refer to circumstances where a practising member prepares or is associated with the issue of statements without audit.

Professional Integrity

The accountant should seek to maintain his professional integrity in his association with an unaudited statement to the same degree as in an audit engagement. He should not place himself in a position where he might be identified directly or indirectly with any financial statement that he has reason to suspect is untrue. Where doubt exists as to the propriety of the statements the accountant should decline to act, unless the client permits an examination sufficient to remove the doubt.

Identification and Disclaimer

Where a practising member associates his name with an unaudited statement, he should give clear indication of the significance of such association. Each such statement should be accompanied by a disclaimer by the accountant which makes it clear that he is not giving an opinion. The disclaimer, or a reference to it, should appear on the principal statements of the set. The disclaimer may state simply that the statements have been prepared without audit, but if other comments are submitted, a definite denial of opinion should be included.

The accountant must avoid giving the impression, by wording or otherwise, that his comments are an expression of opinion on the statements. In such circumstances, the accountant should not be referred to as "auditor" and any headings or references to his comments should avoid use of the words "report" or "certificate", since the terms "auditor's report" and "auditor's certificate" are usually associated with an expression of opinion. If a heading or reference is desired, one suitable designation for the comments regarding an unaudited statement would be "Accountant's Comments".

If the comments include particulars of work performed, the accountant

should make it clear at the outset that he has not performed an audit, and he should consider mentioning important audit procedures which have been omitted.

Choice of Stationery

Practising members, while accustomed to thinking in terms of the responsibility of auditors, recognize also the fact that anyone connected with the preparation of a statement assumes a measure of responsibility appropriate to the part he has played, no matter how complete a disclaimer is issued, or even if his name is not indicated in any way. In this respect, the choice between plain or printed stationery is relatively unimportant. Statements on plain paper, furthermore, are frequently accompanied by a letter of transmittal over the accountant's signature. In any event the use of plain paper does not relieve the accountant from any responsibility he might otherwise have in the circumstances.

Examples of Disclaimers

Without attempting to establish any particular form for the disclaimer of opinion by the accountant who has prepared a statement without carrying out such an audit as would permit him to express an opinion, the following example is offered as a wording that might be suitable in particular circumstances.

The accompanying balance sheet and statement of profit and loss have been prepared by us from the books and records of the company and from information given to us. We did not perform an audit of the accounts and accordingly are not in a position to express an opinion on the financial statements.

Where the accountant identifies himself with the preparation of a tax return without having performed an audit, the following form would be appropriate:

This tax return has been prepared from information supplied by the taxpayer without verification by us.

Advantages of an Audit

Very often the question of preparing an annual statement without audit arises only because the client lacks an appreciation of the nature of the services that might be rendered by the auditor. In such cases the practising member may render a useful service to the client by explaining the advantages to be gained from an audit.

Audit Appointments

The preparation of unaudited statements and reporting thereon does not discharge the obligations assumed by an auditor. A member should not accept the appointment as auditor on terms or in circumstances which would preclude an expression of opinion on the financial statements of the client.

COMMITTEE ON ACCOUNTING AND AUDITING RESEARCH (1956-57)

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BY KENNETH M. PLACE, C.A.

Administrative Accounting

Control Mechanisms

Some time ago there was a lengthy discussion among members of our company on the question of how to exercise control in a business. Naturally our discussion ranged far and wide, and as it progressed, it became more and more obvious that "control" as applied to the functions of management is not so well understood or so simple as might appear on the surface.

What, then, is control? Surely it is ensuring that all levels of the organization carry out their duties in accordance with the policies and plans of management.

If this definition is accepted, how is control accomplished?

Broadly speaking, controls fall into two major categories, those that are purely mechanical and those that require the exercise of judgment. Sometimes the dividing line is very thin, and in many cases both phases may actually overlap in the one operation. In the main, however, policy and execution are the responsibilities of different parts of the organization, and it is management's function to coordinate them. For example, top management will decide whether or not a new plant will be built. Once this decision is made, the implementation becomes the responsibility of a totally different level of management. Continued top management control, however, is usually maintained by routine checks and reports ensuring that the overall approved plan is being followed. The control of policy is the function of one group and the implementation is the function of another. Between these two, there must be some plan for continuous cross-checking of the implementation with the policy.

Probably the largest area of control within most organizations is in the financial field. This is where the accountant's interest lies and where he has the greatest opportunity to exercise his ingenuity. The verb "control" is defined by Webster as (1) to check or verify (payments, etc.) by comparison with a duplicate register; (2) to regulate (financial affairs). The noun is defined as (1) the authority to direct or regulate; (2) a means of restraint, a check. The accountant's task is to design a system of control which ensures the proper performance according to plan but does not unduly hamper and is not too expensive to operate.

All levels of management are necessarily involved in the formulation of a control system. Government legislation establishes certain basic controls which all companies must observe. It sets out minimum accounting requirements and minimum requirements for shareholders' reports, states the powers of directors, and so on. Thus, the structure of control is started. At each level of management, further controls are added. For example, the powers of the president and vice-president, or vice-presi-

dents, are defined by the company by-laws and by the board of directors. Within this general framework, the complete control system is eventually designed.

Reverting to the area of financial control, we might consider in detail some of the mechanisms accountants use. Perhaps the first problem is in the handling of cash, both receipts and disbursements. It is unnecessary to discuss such techniques as the different types of bank accounts (deposit accounts, payroll accounts, automatic transfer accounts, dividend accounts, general accounts), or the countersigning of cheques, the use of protectographs, and other devices to prevent the improper withdrawal of cash. The most important control point in the handling of the company's funds is the document which initiates a payment. This, then, is the first challenge to the accountant. He must design a streamlined procedure which ensures the company against improper payments but does not hinder the payment process and is not too costly.

Here again, in the simple process of the control of expenditures are exemplified the two major areas of control, i.e. the authorization to make the payment and the mechanics of actually making it. Obviously, the authorization is by far the more important, since this action initiates the payment. Even before this, however, the action which committed the company to the expenditure must have taken place, and it, more than either of the other two, is of prime importance because it caused a decision binding on the company. Hence there is another major check-point. Did the person making the commitment have the power to do so? Was it correctly made within overall company policies? Was it a necessary action to implement the company's operations?

This procedure sounds complicated but in actual practice would work to a pattern. The company's purchasing agent would necessarily have been given the authority to make purchases of raw materials, etc. on the company's behalf. In most cases, he would do so by issuing a purchase order, which is the instrument whereby the commitment is made. Internally, though, another action has usually taken place before this, i.e. the request to the purchasing agent to obtain the material in question. Here is the real beginning of the whole cycle and it is here that the controls must be installed to ensure that only purchases necessary for efficient operations are made. Usually these will take the form of combined dollar and coverage limitations on the size of the purchase.

This whole system of control checkpoints can be summarized as follows:

I. Purchase authorization
II. Purchase order
III. Payment document
IV. Release of payment.

Of course, there are a number of subsidiary points to be considered. For instance, power to approve purchase authorizations will be delegated in such a way that the level of authority required will vary with the size of the recommended purchase. The authority for signing purchase orders will be organized so that those which are strictly routine in character can be authorized at a relatively low level in the organization. Payment documents must be designed to answer such questions as "was the material received?", "was it of a satis-

factory quality?", "was the actual quantity invoiced received?", "are the extensions correct?". Finally, the actual release of the payment represents the final control point; the signing officers must be satisfied that the payment is proper in all respects.

While the process of purchasing and paying for materials and services is only one of the functions to be controlled, it is an excellent example of the mechanics of control. It affords the opportunity of reviewing most of the problems encountered without unduly confusing the issues. It is, however, one of the simpler operations because the factors are easy to define and recognize, and each transaction is complete in itself. This is not always the case. Such areas as salaries, sales, production costs and expenses generally do not lend themselves to this straightforward approach. The accountant, then, must devise methods to permit management to satisfy itself that its overall plans are being followed. Probably the most common methods are budgets and forecasts, and various standards of comparison such as process yields, profit margins and return on investment. However, there is no physical limitation here.

One factor, cost, does establish certain practical limitations. Control mechanisms can be developed which will give a positive check on all the operations of any organization, but the greater the degree of control, the greater the cost. It is ridiculous to spend more on a system than can possibly be lost by not having it. On the other hand, it is just as ridiculous to run the risk of a major loss by not having proper and adequate controls. The balance between the degree of control and the cost of achieving must be properly maintained.

One further question must be asked. Who is going to exercise the controls? Naturally the bulk fall within the orbit of the accounting function, but a considerable number split the responsibility. The accountant cannot pass expert legal opinion on agreements, or review the engineering factors in a major construction project.

The design and operation of any system of control presents a major challenge to the accountant, since it offers him the opportunity to display his imagination and overall judgment in a field which is undoubtedly of prime importance to industry today.

BY A. WILLARD HAMILTON, C.A.

The Tax Review

Repair or Improvement

It is probable that most taxpayers in business have been in a quandary at some time or other in attempting to classify, for income tax purposes, an expenditure relating to repairs, alterations or improvements to buildings or equipment. The Income Tax Division would probably be the first to admit that considerable difficulty is frequently encountered in drawing the line between capital and revenue expenditures. While the more courageous, or experienced, taxpayers may have erred on the side of their own liberality in charging off possible contentious items to the expenses of the year, it is equally probable that the less experienced, or more timid, taxpayers may have erred in the opposite direction by charging such expenditures to fixed assets, i.e. capital account.

For the purposes of this review the term "repair" is used to denote those items which are normally chargeable to expense, and "improvement" will define an item usually considered to be of a capital nature. Other words, which seem to have a capital connotation, include renewal, replacement and alteration. Repair has been defined as "restoration by renewal or replacement of subsidiary parts of a whole", and "renewal as distinguished from repair is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject matter under discussion . . . . ". These definitions are considered later.

Until the inception of the Income Tax Appeal Board in 1949, there were practically no Canadian income tax cases which gave assistance in the solution of the difficult problem of determining when certain expenditures of a repair or renewal nature were capital or income disbursements. The taxpayer frequently found it necessary to engage in considerable discussion, if not in battle, with the Taxation Division to arrive at an answer. Satisfactory compromises were often effected with regard to items of a material amount by mutual agreement that such would be written off over a period of years varying from two to five years, and in occasional cases, a somewhat longer period of time.

It is a matter of record that these "in-between" compromises were no longer acceptable with the advent of the Income Tax Act, and now an item which otherwise qualifies as deductible must either be written off in the year of expenditure or added to capital cost, as appropriate. As a consequence, it might be natural to assume that it is more difficult to charge off any substantial amount in the year of expenditure, but this is not entirely correct, as materiality is not a criterion in itself of the deductibility of a repair item.

The Income Tax Appeal Board has decided approximately twenty cases to date dealing with "repairs" which

taxpayers have endeavoured to charge off as expenses in the year of expenditure. While the majority of the decisions have been against the taxpayer, various criteria, which should be helpful in approaching this problem, are becoming evident.

Throughout the Income Tax Appeal Board cases relating to this subject, the taxpayer generally maintains the position that the expense (repair) qualifies for deduction under section 12(1)(a) of the Income Tax Act, being an outlay or expense "made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer". The contrary view is upheld by the Legal Branch of the Department of National Revenue, which contends that the outlay is non-deductible as it constitutes a payment on account of capital (section 12(1)(b)).

CRITERIA

Expenditure must relate to business of taxpayer

It may seem unnecessary to reiterate the point that the expense or outlay must be incurred by the taxpayer for the purpose of earning income from his business; yet several appeals were lost because the expenditures did not meet this test. The repairs must be necessitated by the occupancy of the taxpayer of the premises in the conduct of his income earning activities.

In 1953, the W. E. Coutts Company Limited acquired larger premises at a cost of $750,000 and spent a further $531,000 for extensive alterations and repairs. Part of the premises were leased to another company. In its tax return for that year, the Coutts Company allocated $268,000 to capital account and charged the remainder, or $263,000, to repairs and maintenance. The major portion of this latter amount was found to be a prelude to the occupancy of the building by the appellant and its tenant and was therefore part of the purchase price or capital. The portion which concerned the tenant's needs after occupancy had been assumed was allowed.

In other words, expenses for repair and renewal of buildings anterior to the commencement of operations are capital in nature.

Similarly, expenses incurred for the purpose of disposing of property to the best advantage are considered to be capital. This is well illustrated in the *Montship* case where repairs to two ships just prior to, and in anticipation of, their sale were disallowed. In the *Seagull* case, one of two vessels was used to earn income after repairs had been effected and before the sale took place, which resulted in the allowance of the expenditure relating to that vessel only.

Expenditure must be a "repair"

In addition to the definitions already given for "repair" and "renewal" there are two extracts from the Appeal Board judgments which are useful as guides.

In one of the earlier cases before the Board, the then chairman, Mr. Justice Graham, quoted with approval from Plaxton's "Canadian Income Tax Law",[1] which quotation has been frequently repeated in later judgments:

> However, it is well accepted that incidental repairs which neither materially add to the value of the property nor

[1] which, in turn, was quoted from *The Canadian Chartered Accountant*, May 1938.

> appreciably prolong its life, but which merely keep it in an ordinary, efficient operating condition, should be deducted as an expense item. On the other hand, repairs in the nature of replacements which do appreciably prolong the life of the property and arrest deterioration should be classed as capital expenditures or be charged against depreciation reserve.

Another case, which was won by the taxpayer, involved the replacement of an old engine in a tugboat, at a cost of some $42,000, with a new engine of the same general description and equal capacity. (*Vancouver Tugboat Company Limited*) The submission of the taxpayer is worth recording, as it succinctly summarized the necessary ingredients of a true repair in this language:

> (1) that its expenditure in connection with the replacement of the said engine was a normal recurring repair item known to the towing industry.
>
> (2) that the installation of such engine was the restoration or replacement of a subsidiary part of a whole rather than the replacement of an entirety;
>
> (3) that the installation of such engine was not a change of design or an overall improvement;
>
> (4) that the expenditure on such replacement did not bring about a lasting benefit to the appellant;
>
> (5) that its expenditure in connection with such replacement was not a capital expenditure under any of the provisions of the Income Tax Act.

Mr. Fisher found in favour of the taxpayer and concluded his judgment by stating that in his opinion "the cost of its installation should be treated as a current expense which was made or incurred by the taxpayer for the purpose of gaining or producing income from its business and that the engine was a replacement in the nature of a repair of a subsidiary part of an integral whole".

In connection with repairs to a building or other structure, it is noteworthy that classes 3 and 6 of Schedule B to the Income Tax Regulations extend the definition of a building to include component parts, such as electric wiring, plumbing, sprinkler systems, air conditioning equipment, heating equipment, lighting fixtures, elevators and escalators.

This principle of replacement of a subsidiary part of a whole was recognized in two of the later Income Tax Appeal Board cases decided in favour of the taxpayers.

In the *Oakdale Court Apartment* case, the circumstances were that it was more economical to install new overhead heating pipes than it would have been to incur heavier expenses to rip up floors in order to replace the defective pipes previously in use. The appellant had capitalized the cost of a new furnace installed at the same time, but was permitted to deduct some $7,300 representing the new line of pipes.

In another apartment block case, (*Rogers,* Oct. 1956) an antiquated refrigeration system was scrapped and new individual units purchased and installed. While the new refrigerations might be expected to provide better service than had been provided by the old type, it was considered they would not give any more extensive service and consequently the cost of the new refrigerators was admitted as an expense.

Expenditure must not be an improvement

It appears to be well established that an expenditure made "once and for all" or to create a lasting advant-

age is essentially a capital expenditure and hence not deductible, or as Mr. Fisher expressed it in the *Vancouver Tugboat* case, "I might refer particularly to the general rule laid down in a number of cases that a capital expenditure may be considered to be one that is made once and for all, whereas a current expenditure is one that recurs from time to time."

A capital expenditure also results when improvements or alterations increase the value of the property.

In the Appeal Board case *No. 252*, the taxpayer having started on what he expected would be minor repairs to a wooden wall ended up with a completely new wall of brick. It was admitted that if a sale were contemplated it might be presumed that the appellant would receive a better price for the building. The work was held to have been of a capital nature.

Materiality not a decisive factor

It has generally been thought that where expenditures are substantial in amount they are not likely to be found to be deductible in the year. While it is true that the larger outlays are more likely to represent capital expenditures, materiality of amount is not in itself a barrier to deductibility.

The *Vancouver Tugboat* case, previously referred to, is a good example of this principle as, lacking other evidence, it would readily be assumed that a disbursement of $42,000 must necessarily be an improvement, rather than a repair.

In the *E. A. English Estate* case, it was recognized that proximity of a boat-house and other rented buildings to the water rendered them especially vulnerable to weather conditions and while amounts expended on essential repairs were considered to be out of proportion to the value of the buildings, they were allowed as deductible expenses.

In the *W. E. Coutts* case, this point is inferentially, and inversely, confirmed by the following comment regarding the total of the expenditures not allowed:

> The amount disallowed is impressively large and the tax thereon is correspondingly heavy, but this, of course, in no way affects the application of the principle of income tax law involved . . . .

Expenditure may be part capital

It should be noted that in a number of the decided cases, the taxpayers gained partial victories in that some portion of the expenses claimed were allowed. For instance, in the *S. Levinter* case concerning major repairs following the cessation of war, the cost of the installation of an improved heating system and additional electric wiring were found to be capital, but the costs of repairing sagging floors, of renewing electrical wiring (even if of better quality), of painting ceilings and walls, and of architects' fees, to the extent of $650 out of a total of $1,000, were determined to be deductible items.

A current illustration of this feature is to be found in the practice of the Taxation Division regarding costs incurred in connection with the conversion program (25 cycle to 60 cycle) of the Hydro Commission of Ontario. Expenditures which represent replacement of electrical motors and ancillary property with equipment of equal capacity and standards are allowed as deductions, but to the extent that improvements or betterments take place by increased capacity or rating, the related amounts must be added to capital costs.

The foregoing comments bring out the important point that a careful appraisal by an architect or contractor of the nature of repairs or alterations being undertaken should materially assist in establishing a fair and reasonable division as between capital and expense. An independent opinion is always welcome evidence to the Taxation Division.

Summary

From the foregoing review, it may be useful to list the indicia of what constitutes a repair:

In Favour –

1. An outlay for the purpose of producing income from the business of the taxpayer.
2. The renewal or replacement of subsidiary parts only of an entirety.
3. An outlay which is a normal recurring item.

Against –

1. An outlay precedent to occupation of the premises.
2. An outlay in anticipation of the sale of the property.
3. An outlay which prolongs the life of the property.
4. An outlay which adds to the value of the property.
5. An outlay made "once and for all" or to create a lasting advantage.

After a somewhat lengthy excursion into the realms of probability for classifying "repair" expenditures, it may not be inappropriate to close with the note of warning implied in the words, more than once repeated, of the present chairman of the Appeal Board:

> It is often difficult to differentiate between a capital expenditure and an income expenditure. The object of the expenditure, its nature and its effects are all so many criteria which can help to make the distinction. It is a question of fact which must be determined in the light of the facts and circumstances peculiar to each one.

April

I love the month of April –
Its smiles and gentle rain.
Hope comes to all with these glad words
"Here's April once again",
And yet methinks some joy there lacks
For 'tis the time of income tax.

–G. E. F. Smith, F.C.A.

BY PETER C. BRIANT, B.COM., C.A.

Current Reading

MAGAZINE ARTICLES

ACCOUNTING

"PRICING FOR RETURN ON CAPITAL EMPLOYED" by I. W. Keller. *NACA Bulletin*, January 1957, pp. 635-646.

Return on investment as a measure of operating performance and as a tool for pricing purposes is not a new concept. Mr. Donaldson Brown outlined the approach in 1924. But it is only in the last five years that an abundance of articles on the subject has appeared in accounting journals.

Mr. Keller uses the concept to demonstrate that in the face of cost increases, smaller price increases would result from attempting to maintain a constant return on capital employed than would be the case if a company were to endeavour to maintain its margin on sales.

The use of the concept as a basis for pricing product lines and specific products of a line in a multi-product company is also considered in this article. It concludes with a discussion of the usefulness which the determination of the return on capital employed may have for establishing a price structure which takes into consideration the higher replacement cost of plant and equipment.

It might be noted parenthetically that the author favours the inclusion of fixed assets at original cost rather than depreciated value in the figure for capital employed. He takes the view that the primary problem is to arrive at a new sales price, not to appraise the adequacy of the return. In this context, he says, the basis of asset valuation has no effect on the pricing decision, provided consistency is maintained. He argues, in fact, that when fixed assets are included at cost their ratio to total assets is higher. Thus a greater proportion of the total capital employed will not be increased by increased costs, and a smaller price increase will, therefore, be sufficient to maintain the return.

"MEASUREMENT OF RETURN ON CAPITAL EMPLOYED" by F. J. Muth. *Cost and Management*, January 1957, pp. 7-18.

This article, by an accountant in industry, features a comprehensive discussion of the development and application of the return on capital employed theory, and concludes with a case study demonstrating how the return on the assets employed in the production and distribution of one commodity was almost doubled. The author suggests some basis for allocating total assets to product groups, and indicates a number of ways in which the concept may be used to raise the profitability of products earning only a modest return.

AUTOMATION

"LIVING WITH AUTOMATION: A LOOK AHEAD" by Daniel Bell. *The Management Review*, January 1957, pp. 75-83.

Mr. Bell is a lecturer in sociology at Columbia University and the la-

bour editor of *Fortune*. Consequently, he is not so much concerned with the technical aspects of automation as with its economic effects and social consequences.

One could imagine no more disrupting economic influence than the sudden introduction of all automatic controls into all the factories that could use them. Yet Bell thinks that even this would affect only about 8% of the labour force. In point of fact, of course, automation is spreading its influence only gradually. A growing economy, in Bell's opinion, should be able to absorb the attendant disruptions as readily as it adjusts to shifts in taste, substitution of new products and changes in mores.

Of greater consequence, he says, are the probable social effects of automation: salaried workers taking the place of production workers as automatic processes reduce the number of workers required in production; plants moving away from major cities, the traditional sources of labour supply, and closer to final markets or raw materials; smaller plants, with a more personal relationship between employees and managers, and a carrying over of the social gradations within the plant to the small town in which it is located; depreciation superseding labour as the major element of cost, with more plants operating 24 hours a day to write off the high capital investment. Mr. Bell thinks that more than a quarter of the labour force will be working special hours in the next decade.

BUSINESS

"Is there a New Economic Stability?" by Paul W. McCracken. *Michigan Business Review*, January 1957, pp. 10-17.

Professor McCracken possesses an unusual facility for expressing complex economic ideas in terms which even a layman can understand. In this article, which was originally an address presented to the American Statistical Association, he briefly reviews the course of historical business cycles since 1860, considers the impact of government fiscal operations as a stabilizing factor in the post-war world, and raises some fundamental questions concerning the relative importance of real, monetary, and psychological factors on current business conditions.

The most important of Professor McCracken's conclusions is, perhaps, that, in his opinion, the business cycle is not yet obsolete. "Public policies can be poorly timed," he states. "Individual industry cycles may more nearly get in phase. It is too early to tell how well capital outlays would hold up if a substantial recession were to occur for other reasons. And we may have a new problem in resolving the potential conflict between a stable price level and cyclical stability of income and output. . . "

PROFESSIONAL

"Australian Chartered Accountants' Research and Service Foundation". *The Chartered Accountant in Australia*, November 1956, pp. 259-269.

The Institute of Chartered Accountants in Australia has been granted a licence to establish a Research and Service Foundation, with Professor Mary E. Murphy as its first research and service officer.

Of the 24 objects listed in the

Memorandum of Association, the first four are, perhaps, most significant:

"(1) To promote, encourage and carry out such research and studies in accountancy and other fields of knowledge including accounting, auditing, taxation, law, economics, banking, statistics, management, secretarial procedure, business psychology and office organization as may be of benefit to members in connection with the profession of accountancy.

"(2) To provide for the study of developments both in Australia and overseas in the theory and practice of accounting, auditing and other fields of knowledge of interest to members in connection with the carrying on of their profession as accountants.

"(3) To collect and disseminate information for the benefit of members in connection with the profession of accountancy by means of printed matter, radio, television, lectures, addresses or any other means whatsoever.

"(4) To provide any service intended to benefit members in the conduct of their profession as accountants and for this purpose to undertake any research, inquiry, investigation or study.

"Trends in Corporate Reporting" by R. J. Chambers. *The Australian Accountant*, December 1956, pp. 493-502.

This article presents, in fair detail, the findings of a survey of the reports of 250 companies listed on the Australian stock exchanges in 1955, and shows the comparative data for 1948. It is divided into two main sections: characteristics of the published financial statements and general characteristics of the reports.

The specific characteristics chosen for observation in the first group include: form of the balance sheet, sequence of balance sheet items, balance sheet captions, treatment of shillings and pence and the presence or absence of comparative figures. The size of pages, number of pages, long-term comparisons, additional statistical and financial data, and colour and illustration are the features Professor Chambers looked for in the annual reports.

Some findings of interest:

1. 11% of the companies studied in 1955 continue to present shillings and pence in the financial statements. This represents a decline from 37% in 1948.
2. 28% of the group failed to include comparative figures for the previous year in their 1955 financial statements. In 1948, this feature was omitted in 57% of the cases.
3. In 1948, only one company included a funds statement in its report. By 1955, the number had risen to seven.

Professor Chambers concludes that the readiness to adopt innovations differs from state to state, and that innovation and amplification are not the prerogative of large companies. "Imagination, appreciation of the needs of the investing public . . . and a belief in the value of knowledge on the part of all company supporters are all that is necessary," he writes.

"Company Accounts — What the City Editor Looks For" by I. F.

Richardson. *The Accountant*, January 5, 1957, pp. 6-14.

Foreseeing a continuation of the present tight money situation, Mr. Richardson, city editor of *The Birmingham Post*, issues a timely reminder to professional auditors that public companies should be encouraged to give more information to the public in their annual reports. The demand for funds for business investment might well outrun the supply of loanable funds, in his opinion, unless small savers are induced to invest more of their funds in industrial common stocks. Institutional investors too, which are an increasingly important source of funds, will eventually pass by companies which are secretive about their affairs. One target of his attack is the medium-sized family owned business that converts to a public company to acquire funds from outside sources, but continues in the secretive tradition.

Canadian and American companies have been notably more open about their affairs than have British companies. To illustrate his conception of informative statements, Mr. Richardson points to those for U.S. Steel which, he says, when read together with the chairman's statement, provide almost all the information an investment analyst could require.

"What the Industrialist wants from Management Accounting" by G. A. Boardman. *The Accountant*, December 29, 1956, pp. 678-681.

"Objects of Management Accounting: Views of a Practising Accountant" by J. D. Green. *The Accountant*, November 24, 1956, pp. 535-540.

It appears to be almost axiomatic that industrialists and professional accountants sit on opposite sides of the fence on some important matters relating to management accounting. One such divergence of opinion was commented on in this column in April, 1956. The two papers sighted above, while revealing many areas of agreement, indicate another conflict.

After stressing that completeness and accuracy are essential features of a good accounting report, Mr. Boardman, the industrialist, cites "a knowledge of operational 'know-how'" as a fundamental part of the report-writer's equipment. "Here," he writes, "I believe the advice of auditors, attending the plant two or three times a year, to be worse than useless – in fact, positively misleading." His later recommendation, though not related directly to his earlier comment, seems to stem logically from it; namely, that wherever the audit partnership is large enough, a separate organization and methods department should be operated.

Mr. Green, on the other hand, would rather have management services an integral part of the normal services of a practising chartered accountant.

Most Canadian firms appear to be following the course Mr. Boardman would have them take.

BOOK REVIEWS

Manual of Departments and Agencies of the Government of Canada, by Redmond Quain, Q.C., J. Hamilton Quain, B.A., B.Com., B.C.L., C.A., Redmond Quain, Jr., B.A., B.Com., B.C.L., C.A.; Butterworth & Co. (Can.) Ltd., Toronto; 1956; pp. 313; $10.75

The economic, social and industrial growth of Canada in recent years has been more than matched by the

growth in size and activities of the federal government. The federal government is now a massive organization comprising some 20 departments, over 40 boards and more than 25 Crown corporations.

This book is a manual designed to:

1. Indicate the appeals and recourses open to those who are dissatisfied with rulings and decisions made by government officials.
2. Indicate to businessmen the information and services provided by the government and its agencies.
3. Act as a guide to the appropriate government officials and as a manual of procedures of interest to businessmen.

There is a brief introduction to the organization and function of the federal government and the method of finding the official to whom various matters should be referred.

Subsequent chapters deal with taxes and duties, government contracts, government services to business, transport and communications and miscellaneous items. There are also various organization charts and tables which would be useful to people wishing to contact the proper government official regarding a certain problem. Supplied with the manual is a government telephone directory so that the name and Ottawa telephone number of such officials may be determined.

The manual is prepared to help businessmen deal with the government and includes little or no information on other aspects of government. It does not supply detailed rulings and regulations or give details of taxes and other items covered in other business texts.

This book provides a good reference for those who have to deal with the government or wish to do so. It may not provide the answer to a problem but it will assist in finding the proper department or official who can give the answer.

C. E. BAKER, C.A.
Toronto, Ontario

Cost Reduction, pub. by Gee & Co. (Pub.) Ltd., London, pp. 49; 6/-.

During the postwar period British industry has been faced with the necessity of placing itself in a better competitive position in relation to North American industry. This need led The Institute of Cost and Works Accountants to form a committee to study cost reduction. The report of that committee, now published, is a very readable and useful statement of basic principles.

As may be expected, the greater part of the report deals with principles of factory organization and methods, production planning, purchasing and material control, labour control and working conditions, etc. However, it also handles neatly the principles of marketing, product design and finance. The section on product design is effectively illustrated by means of brief case histories, each chosen to exemplify a principle outlined in the text.

R. E. HERINGTON, C.A.,
Toronto, Ontario.

PUBLICATION RECEIVED

Modern Mill Controls, by N. L. Enrick. Rayon Publishing Corp., 303 Fifth Avenue, New York 16, N.Y. 28 pp., $2.00.

BY J. E. SMYTH, F.C.A.

Students Department

Associate Professor, Queen's University

THE QUESTION CORNER

London, Ontario.

Sir: I am not sure whether there is supposed to be a difference between auditing principles and auditing standards, and if so, what the difference is.

Some of the auditing texts do make a distinction. For example, in *Auditing Procedures,* Dell and Wilson have written: "While principles and standards are closely related there are important differences. Principles define objectives; standards set up criteria to be observed in accomplishing these objectives. Principles outline the justifications underlying auditing; standards determine the level of performance to be obtained in carrying out auditing objectives. Principles are fundamental concepts; standards are broad guides to action."

Other texts seem to use the terms synonymously. For example, in *Auditing Principles and Procedures,* Arthur W. Holmes has said: "Fundamentally auditing standards are the underlying principles of auditing which control the nature and extent of the evidence to be obtained by means of auditing procedures."

Is there a difference between auditing "principles" and "standards"?

D. F. H., A STUDENT-IN-ACCOUNTS.

Editor's Reply

There is, we believe, a difference between "principles" and "standards". In its strict meaning, the term "principles" suggests the existence of a few lofty concepts (difficult to be articulate about) from which specific "standards" flow. Thus we might say, as Montgomery claimed, that the disclosure of truth is a first principle of accountancy; within the framework of this principle we can find a number of "standards" such as that an auditor must be independent (else he cannot insist upon disclosure of the truth), and that the auditor must have adequate technical training (else he cannot recognize the truth). From this point of view, standards are the practical expression of principles, and there are many more standards than principles.

We think we can discern three levels of operation in auditing theory: auditing principles; auditing standards; and auditing procedures. The professional attitude must necessarily be to concentrate upon the development of practical standards which will meet the requirements of every-day practice; and a statement of the underlying principles is left for those future hours of reflection and leisure which never do quite materialize.

The philosopher John Stuart Mill observed that the relation of first principles to a science is not "that of foundations to an edifice, but of roots to a tree, which may perform their office equally well though they be never dug down to and exposed to light".

There are some who argue, perhaps a little cynically, that a continuous preoccupation with the first principles underlying our every-day decisions can only serve to frustrate us, immobilize us, make our work ineffective. They offer an illustration of their point in the story of the malicious toad. The toad is said to have asked a centipede how it was that the centipede could coordinate his nervous and muscular sys-

tem in such a way as to be able to walk using all one hundred legs at once; the centipede thought about the question for a while and has never been able to walk since! Sometimes introspection can be a handicap.

If we can distinguish between "first" principles (in the sense of underlying, fundamental, basic propositions) and "second" principles (in the sense of propositions applicable at the working level, and which may be a part of a larger "first" principle), we may have an explanation of the apparent confusion between the terms "principles" and "standards". A standard is, we submit, very much like a "second" principle.

(*Comments on and criticisms of the editor's reply are invited.*)

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM 1

Intermediate Examination, October 1956
Accounting I, Question 3 (15 marks)

X Co. Ltd. was incorporated on March 31, 1956 with an authorized capital consisting of 5,000 5% preference shares of a par value of $15 each and 5,000 common shares of a par value of $10 each, to take over two existing firms owned by S and T, respectively.

The condensed balance sheets of the businesses owned by S and T as at March 31, 1956 are shown below:

	S	*T*
Assets		
Cash	$ 7,800	$ 3,300
Accounts receivable	3,700	2,100
Inventory	4,800	6,400
Land	4,700	—
Buildings (net)	21,000	—
Equipment (net)	6,000	8,000
	$48,000	$19,800
Liabilities		
Accounts payable	$ 2,000	$ 1,800
Capital	46,000	18,000
	$48,000	$19,800

The purchase agreement provided that:

(i) X Co. Ltd. is to take over all the assets including cash and assume all the liabilities of the two firms after giving effect to the following adjustments to book values:

	S	T
Provision for bad debts	$ 200	$ 600
Inventory, to be valued at	5,000	6,000
Buildings to be valued at (net)	23,000	—
Equipment, to be valued at (net)	8,000	10,000

(ii) For the adjusted value of the net tangible assets contributed:
(1) S is to receive $7,600 in cash, $10,000 on a long-term note, and the balance in preference shares.
(2) T is to receive $3,000 in cash and an equal number of common and preference shares in payment of the balance.

(iii) Goodwill is to be valued at a sum equal to three years' purchase of the combined profits of the two firms, calculated on the average annual profit of the preceding five years of each firm. Total profits for the preceding five years were as follows:

S—$32,560
T—$ 8,190

(iv) S is to receive two-thirds and T one-third of the goodwill so ascertained. The payment to S and T is to be made in fully paid common shares of X Co. Ltd.

Required:

(*8 marks*) (a) Your computation of the details of the preference and common shares of X Co. Ltd. to be issued to each of S and T.

(*7 marks*) (b) The balance sheet of X Co. Ltd. at March 31, 1956, after giving effect to the acquisition of the two firms.

A SOLUTION

X CO. LTD.

DETAILS OF COMPUTATIONS COVERING ISSUE OF CAPITAL STOCK

		S	T	Total
5% Preference Shares — Par Value $15				
1. Net assets of S as at March 31, 1956 per balance sheet	$46,000			
Add increase in value of inventory	200			
Increase in value of buildings	2,000			
Increase in value of equipment	2,000			
	$50,200			
Less provision for doubtful accounts	200			
Adjusted value	$50,000			
Purchased by: cash	$ 7,600			
note	10,000			
shares (21,160)	32,400	$32,400		$32,400
	$50,000			

2. Net assets of T as at March 31, 1956 per balance sheet	$18,000			
Add increase in value of equipment	2,000			
	$20,000			
Less provision for doubtful accounts	600			
Decrease in value of inventory	400			
Adjusted value	$19,000			
Purchased by:				
Cash	3,000			
Preferred shares (640)	9,600		9,600	9,600
Common shares (640)	6,400			
	$19,000			
Common Shares — Par Value $10				
T — see above (640 shares)			6,400	6,400
Goodwill				
Total profits — five years:				
S	$32,560			
T	8,190			
	$40,750			
Average	$ 8,150			
Three years' purchase	$24,450			-
Distributed:				
S (2/3) 1,630 common shares		16,300		16,300
T (1/3) 815 common shares			8,150	8,150
		$48,700	$24,150	$72,850

SUMMARY

S would receive:		
2,160 preferred shares — par value $15	$32,400	
1,630 common shares — par value $10	16,300	$48,700
T would receive:		
640 preferred shares — par value $15	$ 9,600	
1,455 common shares — par value $10	14,550	24,150
		$72,850

(b)

X CO. LTD.

BALANCE SHEET
as at March 31, 1956

ASSETS

Current Assets			
Bank		$ 500	
Accounts receivable	$ 5,800		
Less allowance for doubtful accounts	800		
		5,000	
Inventory, at cost		11,000	
Total current assets			$16,500
Fixed Assets — at cost			
Land		4,700	
Buildings		23,000	
Equipment		18,000	
Total fixed assets			45,700
Goodwill, at cost			24,450
			$86,650

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities		
Accounts payable		$ 3,800
Long term liabilities		
Note payable — S		10,000
Total liabilities		13,800
Capital stock		
Authorized:		
5% preferred — 5,000 shares — par value $15 each	$ 75,000	
Common — 5,000 shares — par value $10 each	50,000	
	$125,000	
Issued and fully paid:		
2,800 preferred shares — par value $15 each	42,000	
3,085 common shares — par value $10 each	30,850	
Total shareholders' equity		72,850
		$86,650

Examiner's Comments

A number of candidates allocated the shares on the basis of equal value instead of equal number. A few used abbreviations on the balance sheet.

PROBLEM 2

Final Examination, October 1956

Accounting I, Question 2 (15 marks)

The R Co. Ltd. has run into financial difficulties. The management offers the general creditors a settlement of 77 cents on the dollar in full satisfaction of their respective claims. This would be payable 21 cents in cash immediately and the balance in 7 monthly instalments. The additional cash required for the initial payment will be secured through the sale of the company's investments. The management will be able to raise $50,000 additional capital if the proposal is accepted by all unsecured creditors.

Some of the creditors believe that the company's proposal should be accepted, while others feel that they would be better off if they sought legal liquidation of the company. CA has been asked to prepare a report to assist the creditors in reaching a decision as to the most advantageous course of action.

The following is a condensed balance sheet of R Co. Ltd. as at June 30, 1956:

R CO. LTD.

BALANCE SHEET

as at June 30, 1956

ASSETS		LIABILITIES	
Cash on hand	$ 10,000	Bank loan (secured by hypothecation of book debts)	$ 40,000
Accounts receivable	80,000	Accounts payable	153,000
Inventories — at cost	30,000	Taxes on income	5,000
Prepaid insurance	525	Accrued wages and salaries	3,000
Investments	30,000	Mortgage payable on fixed assets	25,000
Fixed assets (net)	120,000	Capital stock	70,000
Goodwill	20,000	Deficit	(5,475)
	$290,525		$290,525

CA estimates that if the company is forced into bankruptcy:

(i) Accounts receivable will realize 60 cents on the dollar.
(ii) Inventories could be sold for 65% of their cost, with the exception of special parts included in the inventory at $1,000 which will realize only $150 as scrap.
(iii) 20% of the prepaid insurance would be recovered.
(iv) Investments would be sold for $31,645.
(v) Fixed assets could be sold for $84,000.
(vi) Costs of liquidation would be $5,000.

Required:

(*10 marks*) (a) Prepare a statement of affairs and deficiency account which CA would submit to the creditors

(*5 marks*) (b) What considerations should CA suggest that the creditors take into account before deciding on a course of action?

A SOLUTION

R CO. LTD.

STATEMENT OF AFFAIRS
as at June 30, 1956

Book Value			*Expected to Realize*
	ASSETS		
Assets pledged to pay secured creditors			
$120,000	Fixed assets	$84,000	
	Less mortgage	25,000	$ 59,000
80,000	Accounts receivable	48,000	
	Less bank loan	40,000	8,000
Assets not pledged			
10,000	Cash		10,000
30,000	Inventories		19,000
525	Prepaid insurance		105
30,000	Investments		31,645
20,000	Goodwill		
$290,525	Free assets		$127,750
	Less preferred claims and liquidation fees		13,000
			$114,750
	Deficiency to creditors		38,250
			$153,000

	LIABILITIES		*Expected to Rank*
Preferred claims			
$ 3,000	Salaries	(per contra)	
5,000	Taxes	(per contra)	
Fully secured			
40,000	Bank loan	(per contra)	
25,000	Mortgage	(per contra)	
Unsecured			
153,000	Accounts payable		$153,000
64,525	Capital less deficit		—
$290,525			$153,000

DEFICIENCY ACCOUNT

R CO. LTD.
June 30, 1956

Shrinkage in assets:		*Compensated by:*	
Accounts receivable	$ 32,000	Shareholders equity	$ 64,525
Inventories	11,000	Gain on investments	1,645
Prepaid insurance	420	Deficiency to creditors	38,250
Fixed assets	36,000		
Goodwill	20,000		
Liquidation expense	5,000		
	$104,420		$104,420

(b) **Considerations which should be taken into account in reaching a decision**

If the creditors were to force the company into immediate liquidation, they would receive 75c on the dollar. They must therefore decide whether 75c now is better than 77c spread over seven months. There is a greater element of risk in the latter course because the realization of the entire 77c on the dollar will depend on the company's ability to operate profitably during the period; the possibility exists of course that the company may only get into further difficulties.

The ability to raise an additional $50,000 capital is not in itself a decisive point in favour of the compromise plan, in view of the fact that the company's present current liabilities are $201,000.

PROBLEM 3

Final Examination, October 1956
Accounting I, Question 3 (18 marks)

The X Co. Ltd. was incorporated under the Companies Act (Canada) in 1940 as a manufacturing concern. On July 31, 1956, the fiscal year end date, the company ceased operations. It liquidated all its assets and paid all its liabilities. All outstanding preference shares were redeemed on August 1, 1956. The directors wish to complete the winding-up procedures by the end of August 1956 and are most anxious to take such action as is necessary to ensure that the common shareholders will obtain the most advantageous settlement.

The condensed audited balance sheet of the company as at July 31, 1956, after liquidation, is as follows:

X CO. LTD.

BALANCE SHEET

as at July 31, 1956

ASSETS

Cash	$900,000

LIABILITIES

Capital:	
1,600 – 5% preference shares of a par value of $100 each, redeemable at $105	$160,000
30,000 – common shares of a par value of $10 each	300,000
Earned surplus	440,000
	$900,000

The following information relates to the company's operations:

(i) The company's "Undistributed income" for tax purposes amounted to:

$410,000 as at July 31, 1956
$200,000 at at July 31, 1949

(ii) Annual dividends of $8,000 had been declared and paid to preferred shareholders on July 31 each year since the business commenced.

(iii) No dividend had been paid to common shareholders prior to June 30, 1946, but annual dividends of $18,000 had been declared and paid to these shareholders on June 30, 1946 to 1956 inclusive.

Required:

Your calculation of the maximum amount of cash after personal income taxes which could be retained by the common shareholders on the winding-up of the company. You may assume that the shareholders' marginal rate of tax is 49%.

A SOLUTION

X CO. LTD.

Calculation of Maximum Amount of Cash after Personal Income Tax which can be retained by Common Shareholders on Winding Up Company August, 1956

(1) Earned surplus as at July 31, 1956 is made up of:		
Undistributed income	$410,000	
Sundry capital profits (presumed)	30,000	
		$440,000

(2) Payment of tax on 1949 undistributed income:		
15% of $200,000		30,000
(3) Payment of tax on undistributed income accumulated since July 31, 1949:		
(a) Undistributed income July 31, 1949 – July 31, 1956	210,000	
Premium paid on redemption of preferred shares, August 1, 1956 – 1,600 shares @ $5	8,000	
	202,000	
Tax paid by company on premium paid – 20% of $8,000	1,600	
Undistributed income July 31, 1949 – August 1, 1956	200,400	
(b) Dividends paid August 1, 1949 to July 31, 1956:		
Preferred shares – 7 years @ $8,000	56,000	
Common shares – 7 years @ $18,000	126,000	
	182,000	
Tax is 15% of lesser of $220,400 and $182,000:		
15% of $182,000		27,300
(4) Distribution of tax-paid undistributed income:		
for 1949 – ($200,000 – $30,000)	170,000	
after 1949 – ($182,000 – $27,300)	154,700	
		324,700
(5) Total 15% tax and tax-paid undistributed income		$382,000
(6) Distribution of balance of undistributed income:		
Undistributed income to July 31, 1949	200,000	
Undistributed income July 31, 1949 to August 1, 1956	200,400	
	400,400	
Less Total 15% tax and tax-paid undistributed income	382,000	
Balance of undistributed income		$ 18,400
(7) Portion of balance of undistributed income retained by shareholders after payment of personal income tax thereon:		
Amount subject to personal income tax	$ 18,400	
Personal income tax payable thereon (49% – 20%)	5,336	
		$ 13,064
(8) Maximum cash after personal income tax which may be retained by common shareholders:		
Payment in respect of capital – 30,000 shares @ $10	$300,000	
Capital surplus, tax-free ($440,000 – $410,000)	30,000	
Tax-free dividends	324,700	
Balance of undistributed income after personal tax	13,064	
		$667,764

Examiner's Comments

The examiner reports that a number of students did not prepare proper schedules. Some failed to recognize the difference between earned surplus of $440,000 and undistributed income for tax purposes of $410,000 as of July 31, 1956.

PROBLEM 4

Final Examination, October 1956
Auditing I, Question 2 (14 marks)

In 1950, X Co. Ltd., incorporated under the Companies Act (Canada), purchased 65% of the issued common shares of R Co. Ltd. During the fiscal year ended December 31, 1955, additional shares were purchased bringing the interest of X Co. Ltd. up to 75%. CA has been the auditor of X Co. Ltd. for several years.

Required:

(*10 marks*) (a) Outline the procedures which CA should undertake in order to form an opinion on the item "Interest of minority shareholders in subsidiary company" appearing in the consolidated balance sheet of X Co. Ltd. as at December 31, 1955, assuming that:

(i) CA is also the shareholders' auditor of R Co. Ltd.

(ii) CA is not the shareholders' auditor of R Co. Ltd. but the accounts have been reported upon by another firm of chartered accountants.

(*4 marks*) (b) If the accounts of the subsidiary company had been reported upon by another firm of chartered accountants, what effect, if any, does this have on the report submitted by CA on the consolidated accounts?

A SOLUTION

(a)

X CO. LTD.

Audit Procedures to Verify Minority Interest on Consolidated Balance Sheet, Dec. 31, 1955

(i) *Where CA is also the auditor of the subsidiary, R Co. Ltd.*

1. By reference to the stock register of R Co. Ltd., determine that the total number of shares held by the minority interest comprises 25% of the stock outstanding. Check the changes in ownership of capital stock which have taken place during the year.
2. Determine the minority interest in the net assets of R Co. Ltd. included in the consolidated statements of X Co. Ltd. by reference to the accounts for share capital, surplus and proprietorship reserves in the books of R Co. Ltd.
3. See that proper adjustment has been made for inter-company accounts.

4. By reference to the previous year's working papers, changes in capital stock ownership during the current year, and the statements of profit and loss and surplus for the current year, reconcile the minority interest as of the previous year-end with that at the current year-end.

(ii) *Where CA is not the auditor of R Co. Ltd.*

1. Obtain a copy of the audited financial statements of R Co. Ltd. from the auditor of R Co. Ltd.
2. By reference to the number of shares of R Co. Ltd. held by X Co. Ltd., as shown by their investment account, and to the outstanding capital stock, as shown by the audited financial statements of R Co. Ltd., determine the percentage of the minority interest in R Co. Ltd. Confirm this percentage with the auditor of R Co. Ltd.
3. Calculate the minority interest by applying the percentage interest to the amount of the net assets of R Co. Ltd.
4. As in (i), ascertain that proper adjustment has been made for intercompany accounts, and reconcile the change in the amount of the minority interest over the current year.

(b) If the accounts of R Co. Ltd. have been reported upon by another firm of chartered accountants, the auditor's report accompanying the consolidated balance sheet of X Co. Ltd. should refer in its scope paragraph to the fact that the accounts of the subsidiary have been examined by other auditors. Any qualification in the auditor's report of R Co. Ltd. should be carried to the auditor's report on the consolidated financial statements of X Co. Ltd.



Manitoba

D. Grant McIntosh, C.A. is now with the accounting department of the Canadian National Railways, Winnipeg.

Ontario

James C. Sutherland, C.A. announces the removal of his office to Rm. 110, 1175 Bay St., Toronto.

Samuel S. Speigel & Co., Chartered Accountants, announce the removal of their offices to 289 Cedar St., Sudbury.

J. H. Moore, C.A. has been appointed executive vice-president and managing director of John Labatt Ltd., London.

N. A. Henry, C.A. has been appointed comptroller of A. Newman & Co. and secretary-treasurer of Newman Structural Steel Ltd., St. Catharines.

Herbert C. Rogers, C.A. has been elected to the board of directors of Kist Canada Ltd., Toronto.

A. Ross Ashforth, C.A. has been appointed comptroller of Guaranty Trust Co. of Canada, Toronto.

B. D. Whitehouse, C.A. has been appointed chief accountant of Dominion Bridge Co. Ltd., Ontario Division.

T. J. Forsyth, C.A. is now associated with the Sun Life Assurance Co. of Canada, Toronto University Branch, as a life underwriter.

Crawford, Burley & Co., Chartered Accountants, announce the opening of an office for the practice of their profession at 9 East Main St., Welland.

Quebec

Samuel W. Koch, C.A. announces the removal of his office to Ste. 415, Professional Centre Bldg., 5757 Decelles Ave., Montreal.

Masse, Vien & Co., Chartered Accountants, Hull, announce the admission to partnership of Paul Masse, C.A.

A. C. Lawson, C.A. has been appointed vice-president, export division, Canadian Car & Foundry Co. Ltd., Montreal.

K. H. Scott, C.A. has been appointed divisional accountant of DuPont Co. of Canada (1956) Ltd., Montreal.

David Finestone, C.A. announces the removal of his office to Ste. 415, 5757 Decelles Ave., Montreal.

Gerard F. Lapointe, C.A. announces the removal of his office to 1A St-Elzear St., Riviere-du-Loup.

Gerald Prefontaine, C.A. announces the opening of an office for the practice of his profession at 250 Besserer St., Ottawa.

W. E. Falconer, C.A. has been appointed controller of Gillette Safety Razor of Canada Ltd., Montreal.

J. G. Telfer, C.A. has been appointed comptroller of Laminated Structures Ltd., Montreal.

The editor welcomes information for this column. News of members and provincial Institutes' activities received up to and including the 13th of the month will appear in the following issue of the journal.

INSTITUTE NOTES

NEWS FROM SASKATCHEWAN

The Regina Chartered Accountants Club presented a panel discussion on student training following a dinner held on Thursday, March 7. The members on the panel were W. E. Clarke, C.A. and G. R. D. Campbell, C.A., with D. E. Cuddington as moderator.

Thirteen new chartered accountants from southern Saskatchewan received their certificates at a ceremony on February 23 at the Legion Hall in Regina. The address was given by W. Givens Smith, F.C.A., president of the Canadian Institute of Chartered Accountants. Awards were presented to prize winners as follows: Dean Neilson medal for the highest marks in the final examination, R. B. Richards; Watson Sellar prize for the highest marks in auditing, R. B. Richards; Ferguson Memorial prize for the highest marks in accounting, J. R. Morrow.

CALGARY C.A. CLUB

A. D. McTavish, secretary of the Institute of Chartered Accountants of Alberta, addressed the February meeting of the Calgary Chartered Accountants' Club on "Challenges of the Institute". R. P. Alger, president of the club, presided at the meeting which was attended by more than 60 members.

P.E.I. INSTITUTE

C.A. certificates were presented to successful candidates in the 1956 final examinations at the semi-annual dinner meeting of the P.E.I. Institute in Charlottetown on March 1. The Institute prizes were presented to the following students who obtained the highest marks in the 1956 examinations: final, John Gorril; intermediate, Joseph Arsenault.

The guest speaker was Dr. George C. Fisher, local representative and instructor for the Dale Carnegie Institute, who spoke on "Human Relations".

C.A. CLUB OF OTTAWA

The regular luncheon meeting of the Chartered Accountants' Club of Ottawa, held in the Chateau Laurier on February 21, was addressed by the Hon. John J. Connolly, Q.C., who spoke on "The Senate of Canada".

QUEBEC INSTITUTE

Provincial Conference: The program of the first annual provincial conference of the Quebec Institute, to be held on Wednesday, June 12, will include three panel meetings and eight group discussions.

Tentative subject for two of the meetings, which will be held separately in English and French, is "The Preparation of Statements for Use in Prospectuses and Filing with the Quebec Securities Commission". In addition, there is to be a bilingual panel meeting of which the topic is "The Application of Electronic and Mechanical Accounting Methods to Medium-sized Companies".

During the afternoon separate discussion groups will be held in French and English. The English-language subjects include "Modern Audit Methods", "Forms Control and the Retention and Destruction of Records" and "The Audit of and Retention of Controls in Mechanized Accounting Systems". Discussions in French include "Problems Encountered in the Audit of Municipalities", "The Functions of an Internal Audit Department and its Relation to External Auditors" and "The Administration of the Professional Office with Emphasis on Student Training".

Separate discussion groups will again deal with, "The Education and Training of

Chartered Accountants for Positions of Responsibility in Industry and Commerce".

School Speakers: The School Speaker Committee, under the joint chairmanship of D. F. Rennie and André Côté, is arranging a great many engagements for a panel of volunteer speakers to address high schools in the Montreal area.

Students' Society Winter Outing: The Students' Society held a very successful winter outing on Saturday, March 9, at Morin Heights in the Laurentian Mountains. Skiing events, a sleigh ride and after-dinner dancing in the lounge of the Bellevue Hotel were all well attended. A number of prizes were distributed. The Social Committee hopes this outing will now become an annual event.

Conferences for Students: A series of conferences will be held in April and May to assist 4th and 5th year students to prepare for their spring class examinations. The conferences, in the form of round table discussions led by recent graduates, will take place in the Chartered Accountants Building, 630 Lagauchetière Street West, Montreal. Dates and subjects of the meetings are as follows: April 24 — Partnerships; April 29 — Cost Accounting; May 1 — Mergers and Consolidations; May 6 — Investigations; May 8 — Income Tax.

ONTARIO INSTITUTE

Chartered Accountants Universities Research Trust Fund: The Council of the Institute has announced the establishment of this fund for the advancement of research by teachers of accounting and related subjects in the Ontario universities. Past presidents K. L. Carter and H. E. Crate and the president, J. R. M. Wilson, have been appointed trustees of the fund, and practising members and others will be given the opportunity to make financial contributions in the near future. The Council hopes that about $5,000 will be contributed which should be adequate for the grants that may be made in the next two years. The fund is experimental in nature but will doubtless be continued if the expected benefits from its operation are realized.

74th Anniversary Dinner: The 724 guests at the dinner on March 8 were held spellbound by the speaker, Mr. W. Harold Rea, F.C.A., who recounted his experiences in Russia during a ten-day trip last October. The dinner was one of the largest and most successful held by the Institute and was ably presided over by J. R. M. Wilson. During the dinner Mr. Wilson announced the election to life membership of Messrs. A. G. Calder and F. Page Higgins who had been admitted to membership in 1906-07. Both are Fellows of the Institute and past presidents.

Chartered Accountants University Entrance Scholarships: At the anniversary dinner, the president announced that the Institute would give two scholarships of $1,000 each to applicants who obtain the highest standing in eight Grade XIII papers in the Ontario Department of Education examinations held in June, 1957. The applicants must subsequently enroll in the commerce or business administration courses at any of the Ontario universities. The Council hopes that the scholarships will be useful in encouraging good students to enroll in the business schools. Applications should be made to the Institute before May 31, 1957.

Affiliation: The following were admitted to membership by affiliation on March 8, 1957:

F. B. Campbell (Que '35), C. W. J. Leonardi (Eng & Wales '51) and G. E. Pearson (Alta '53).

N.S. INSTITUTE

The annual convocation dinner and dance was held at the Nova Scotian Hotel on March 7 with about 75 couples in attendance. Following the dinner, Hon. R. L. Stanfield, Premier of Nova Scotia, presented C.A. certificates to the successful candidates and then addressed the group. The Governor-General's gold medal for the highest standing in Canada in the final examinations was presented to Edwin C. Harris by Gerald E. Martin, past president of the C.I.C.A. Harold Crosby, vice-president of the Nova Scotia Institute, presided at the dinner.

OBITUARIES

HENRY W. FORD

The Institute of Chartered Accountants of Alberta announces with deep regret the death of Henry W. Ford on February 7, 1957.

Mr. Ford was born in 1878 in London, England and came to Canada in 1903. He owned and edited the Cupar Herald, Cupar, Saskatchewan for nearly three years before coming to Alberta in 1913. He was admitted to membership in the Alberta Institute in 1923 and practised in Calgary and Bassano. From 1934 to 1946 he was employed by the Customs and Excise Division of the Department of National Revenue.

To his family the members of the Institute extend their sincere sympathy.

F. A. NIGHTINGALE

The Institute of Chartered Accountants of Nova Scotia announces with deep regret the death of Francis Alfred Nightingale on February 17, 1957 at North Miami Beach, Fla. Retired since 1954, Mr. Nightingale was formerly senior partner of Nightingale, Hayman & Co., Chartered Accountants, Halifax.

Mr. Nightingale was born in England and came to Halifax as a boy in his teens. In 1922 he was admitted to the Institute of Chartered Accountants of Nova Scotia. He served in various capacities with the Institute and in 1937-38 was president of the Canadian Institute of Chartered Accountants. He was a Canadian delegate to the International Congress of Accountants in Berlin in 1938.

Prominent in community affairs, Mr. Nightingale at the time of his death was vice-chairman of the Public Service Commission and president of the Board of Management of the Children's Hospital. He was a past president of the Gyro Club of Halifax and of Gyro International. A member of the Halifax Board of Trade, he also belonged to the Ashburn Golf Club and the Waegwoltic Club.

Mr. Nightingale was a member of First Baptist Church and was chairman of its Board of Managers.

To his widow and family the members of the Institute extend sincere sympathy in their bereavement.

J. B. A. MERINEAU

L'Institut des Comptables Agréés de Québec annonce avec un profond regret le décès de J. B. A. Mérineau le 25 janvier 1957.

Monsieur Mérineau était né à Montréal. Il a fait ses études à l'Académie St-Jean-Baptiste et est un gradué de l'Université de Montréal. Il a fait partie du personnel de la Banque d'Hochelaga pour ensuite être à l'emploi de la Ville de Montréal. En 1926 il était promu au rang de contrôleur et vérificateur et en 1953 it était nommé vérificateur de la Ville, le poste qu'il détenait au moment de sa mort.

Monsieur Mérineau a été admis comme membre de l'Institut des Comptables Agréés de Québec le 17 avril 1946.

Durant son emploi pour la ville, il était membre de la Commission métropolitaine en qualité de conseiller financier. Il était aussi un ancien président du "Cost and Management Institute" ainsi que de l'Institut du Radium; membre à vie de l'hôpital Notre-Dame et membre de plusieurs commissions et comités civils s'occupant des fonds de pension des policiers et des pompiers.

Les membres de l'Institut expriment leurs sincères condoléances à Madame Mérineau ainsi qu'à sa famille.

CLASSIFIED ADVERTISEMENTS

Rates: *Positions wanted, $7.00 per column inch; Positions offered, $10.00 per column inch; Open rate, $17.00 per column inch.*

All replies to box numbers should be sent to The Canadian Chartered Accountant, 69 Bloor Street East, Toronto 5, Ontario.

Closing date is 14th of preceding month

POSITION WANTED: Associate of Institute of Chartered Accountants in England and Wales arriving in Canada early May requires employment preferably in industry in Southern Ontario. Age 42. Full details of varied experience both professional and commercial will be given to interested employers. H. R. Scott, 13 High St., Stratford-on-Avon, Warwickshire, England.

CHARTERED ACCOUNTANT, Toronto, gross approx. $9,000, interested in joining forces with other practitioner with similar volume. Box 642.

CHARTERED ACCOUNTANT, aged 28, presently in B.C. seeks permanent position in industry or with small practising firm in expanding area offering concrete prospects of partnership arrangement. Prepared to relocate anywhere in Canada. Box 644.

BUSY COMMERCIAL LAWYER has fully air-conditioned private and outer office, secretarial, telephone/reception facilities, for lease on share-cost basis to responsible accountant. Bloor & Jarvis Sts. Toronto. Box 645 or WA 4-0997.

C.A., age 31, public accounting, taxation, industrial experience desires responsible position with practising firm offering prospect of partnership. Box 646.

CHARTERED ACCOUNTANT WANTED: with a Bachelor of Commerce or equivalent degree who has had a few years of good experience since becoming a chartered accountant. An outstanding opportunity in the profession is available for an alert man with initiative and with more than ordinary ability. Reply in confidence. Box 648.

RECENT GRADUATE required to effect amalgamation two established practices in interior B.C. city. Suitable salary, leading to partnership. Box 649.

CHARTERED ACCOUNTANT: The University of Alberta invites applications from chartered accountants holding a university degree for the position of assistant professor in the department of accounting at an initial salary of $5,000 or higher depending on experience and qualifications, duties to commence September 1, 1957. Reply enclosing recent photo and give full particulars as to academic background, experience, references, age, to the undersigned not later than May 15, 1957.

Head of the Department of Accounting
University of Alberta
Edmonton, Alberta.

ACCOUNTANT required for a new industry located at Baie Comeau, P.Q., an assistant accountant, not over 33, preferably with some professional qualification. Job will include general and cost accounting duties with some participation in budget studies and financial reports. New house will be available, if desired. Salary commensurate with ability. This is a permanent position with sound future prospects. Apply in confidence to Box 643, giving full particulars of experience, etc.

ASSOCIATE STUDENT with 10 years varied experience, Jewish, married, 35, presently living in Winnipeg wishes to relocate in Toronto. Seeks responsible position with C.A. firm with eventual partnership possibilities if successful in October examinations—or in industry with good advancement prospects. Box 647.

CHARTERED ACCOUNTANT required in Toronto office of firm of chartered accountants to work with partner handling tax practice. Extensive experience in taxation is not necessary but applicant should have interest and aptitude in the taxation field. Staff members of the office have been advised. Reply to Box 650 giving age, experience and education.

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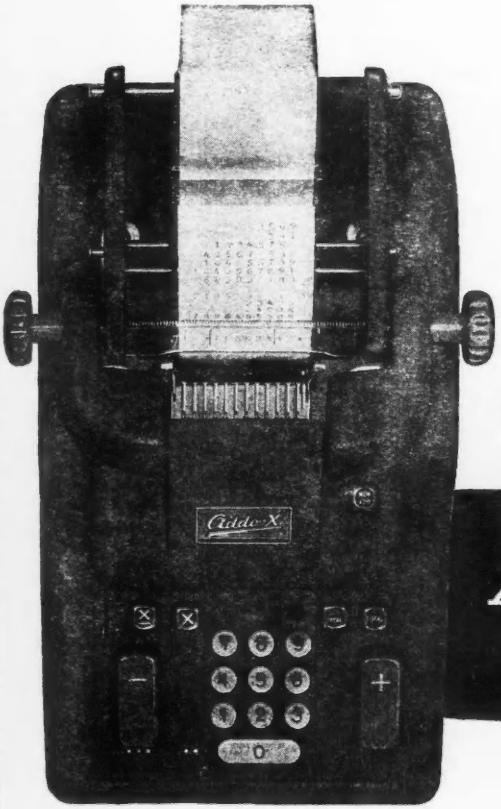
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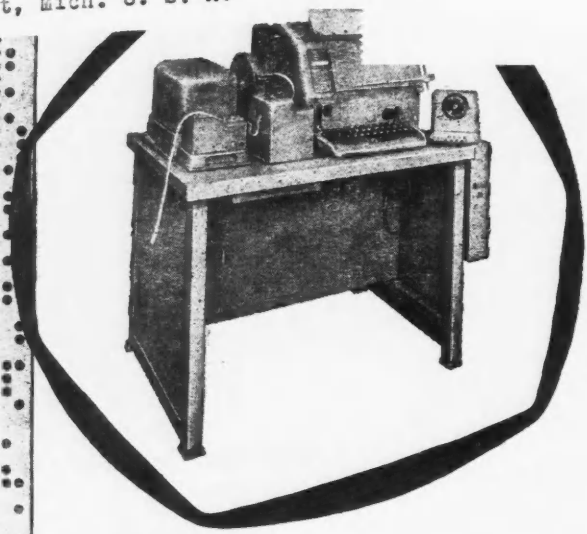
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